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No. 82-500

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1982

THE SOUTHLAND CORPORATION, et al.,
Appellants,

vs.

RICHARD D. KEATING, et al.,
Appellees.

On Appeal from the Supreme Court of California

BRIEF OF APPELLEES

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TABLE OF CONTENTS

	Page
Statement of the case	1
Summary of the argument	3
Argument	5
I	
This court does not have jurisdiction over this case	5
A. The arbitration clause at issue does not include, within its scope statutory claims under the California Franchise Investment Law	6
B. Southland did not raise class arbitration as a federal issue in the court below	11
C. There is no final judgment	13
II	
The Federal Arbitration Act does not affect the right of a state to specify a judicial forum for resolution of statutory claims	18
A. An intent to preempt cannot be inferred where it would cripple the exercise of state police power in a substantive area in which Congress has intended state law to operate vigorously	19
B. Congress did not intend to include either state or federal statutory claims within the coverage of the Act	22
C. Parallel state arbitration acts also exclude from arbitration important statutory claims for which access to the courts is deemed essential	27
D. The Federal Arbitration Act defers to state law on issues of validity such as the Antiwaiver Provision of the Franchise Investment Law	31

TABLE OF CONTENTS

Page

E. The Federal Arbitration Act would be unconstitutional if applied to bar state courts from adjudicating important state rights for which access to a judicial forum is guaranteed by the state legislature 33

III

The California court's decision to consider classwide arbitration of the common law claims does not impair any federal right 38

A. The California courts may void the arbitration clause altogether as unconscionable under general principles of California contract law 38

B. State courts are entitled to apply their own procedures in enforcing a right to arbitrate under the Federal Arbitration Act 41

C. The judiciary has always played a major role in structuring and implementing arbitration procedure under state and federal law 43

D. Class arbitration is an appropriate experiment in preserving both parties' rights in the context of an adhesion contract 46

Conclusion 50

TABLE OF AUTHORITIES CITED

Cases

Page

A & E Plastik Pak Co. v. Monsanto Co., 396 F.2d 710 (9th Cir. 1968) 26

Aimcee Wholesale Corp. v. Tomar Products Inc., 21 N.Y.2d 621, 237 N.E.2d 223, 289 N.Y.S.2d 968 (1968).. 28

Alabama State Federation of Labor v. McAdory, 325 U.S. 450 (1945) 33

Alexander v. Gardner-Denver Co., 415 U.S. 36 (1974) 8, 9, 26, 27, 34

Allegaert v. Perot, 548 F.2d 432 (2d Cir.), *cert. denied* 432 U.S. 910 (1977) 26

Allison v. Medicab International, Inc., 92 Wash.2d 199, 597 P.2d 380 (1979) 29

American Airlines, Inc. v. Louisville & Jefferson C.A.B., 269 F.2d 811 (6th Cir. 1959) 14, 31, 35

American Pipe & Construction Co. v. Utah, 414 U.S. 538 (1974) 46

American Safety Equipment Corp. v. J. P. Maguire & Co., 391 F.2d 821 (2d Cir. 1968) 26

Atkinson v. Sinclair Refining Co., 370 U.S. 238 (1962).. 6

Bache Halsey Stuart Shields, Inc. v. Moebius, 531 F.Supp. 75 (E.D. Wis. 1982) 31

Bailey v. Anderson, 326 U.S. 203 (1945) 13

Barrentine v. Arkansas-Best Freight System, 450 U.S. 728 (1981) 8, 26

Barron v. Tastee Freez International, Inc., 482 F.Supp. 1213 (E.D. Wis. 1980) 30, 31

Bernhardt v. Polygraphic Co. of America, 350 U.S. 198 (1956) 27

Bigge Crane and Rigging Co. v. Docutel Corporation, 371 F.Supp. 240 (E.D.N.Y. 1973) 44

Table of Authorities Cited

Cases

Page

Bos Material Handling, Inc. v. Crown Controls Corp., 137 Cal.App.3d 99, 186 Cal.Rptr. 740 (1982) 15, 28

Boynton v. Carswell, 238 Ga. 417, 233 S.E.2d 185 (1977), rev'd. on other grounds, Callaway v. Carswell, 240 Ga. 579, 242 S.E.2d 103 (1978) 47

Breyer v. First National Monetary Corp., 548 F.Supp. 955 (D.N.J. 1982) 26

Busic v. United States, 446 U.S. 398 (1980) 22

Butler v. Claxton, 221 Ga. 620, 146 S.E.2d 763 (1966) .. 37

Chandler v. Florida, 449 U.S. 560 (1981) 41

City of Burbank v. Lockheed Air Terminal, Inc., 411 U.S. 624 (1973) 20

City of San Jose v. Superior Court, 12 Cal.3d 447, 115 Cal.Rptr. 797, 525 P.2d 701 (1974) 47

Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949) 13

Compania Espanola de Pet., S.A. v. Nereus Ship., 527 F.2d 966 (2d Cir. 1975), *cert. denied,* 426 U.S. 936 (1976) 44

Comprehensive Merch. Cat., Inc. v. Madison Sales Corp., 521 F.2d 1210 (7th Cir. 1975) 32

Cox Broadcasting Corp. v. Cohn, 420 U.S. 469 (1975) 13, 14, 17

Crowell v. Benson, 285 U.S. 22 (1932) 37

Cunningham v. Dean Witter Reynolds, 550 F.Supp. 578 (ED. Cal. 1982) 15

Curran v. Merrill Lynch, Pierce, Fenner & Smith, 622 F.2d 216 (6th Cir. 1980) aff'd. ..... U.S. ....., 102 S.Ct. 1825 (1982) 26

Dickenson v. Heinold Securities, Inc., 661 F.2d 638, (7th Cir. 1981) 15

Dillingham v. McLaughlin, 264 U.S. 370 (1924) 32

Table of Authorities Cited

Cases

Page

Duplan Corp., etc. v. W. B. Davis Hosiery Mills, 442 F.Supp. 86 (S.D.N.Y. 1977) 14

Durley v. Mayo, 351 U.S. 277 (1956) 11

Durst v. Abrash, 22 A.D.2d 39, 253 N.Y.S.2d 351 (1964) 28

Equal Employment Opportunity Commission v. Wyoming, ... U.S. ....., 103 S.Ct. 1054 (1983) 35

Erie R. Co. v. Tompkins, 304 U.S. 64 (1938) 12, 24, 34, 35

Ferro Union Corp. v. SS Ionic Coast, 43 F.R.D. 11 (S.D.Tex. 1967) 44

Fletcher v. Security Pacific National Bank, 23 Cal.3d 442, 153 Cal.Rptr. 28, 591 P.2d 51 (1979) 40

Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132 (1963) 19

Fuller v. Guthrie, 565 F.2d 259 (2d Cir. 1977) 6

General Telephone v. Falcon, 457 U.S. 147 (1982) 46

Gillette v. Miner, ... U.S. ....., 103 S.Ct. 484 (1982) 14

Green v. Obledo, 29 Cal.3d 126, 172 Cal.Rptr. 206, 624 P.2d 256 (1981) 48

Greenfield v. Villager Industries, Inc., 483 F.2d 824 (3d Cir. 1973) 48

Gulf Oil Co. v. Bernard, 452 U.S. 89 (1981) 46

Hardware Dealers Mutual Fire Insurance Company v. Gladden, 284 U.S. 151 (1931) 34

Harris v. Shearson Hayden Stone, Inc., 82 A.D.2d 87, 441 N.Y. S.2d 70 (1981), aff'd. mem., 56 N.Y.2d 627, 435 N.E.2d 1097, 450 N.Y.S.2d 482 (1982) 47

Herman & MacLean v. Huddleston, ... U.S. ....., 103 S.Ct. 683 (1983) 9

Hidrocarburos y Derivados, C.A. v. Lemos, 453 F. Supp. 160 (S.D.N.Y. 1978) 44

Table of Authorities Cited

Cases

	Page
Hope v. Superior Court, 122 Cal.App.3d 147, 175 Cal. Rptr. 851 (1981), cert. denied, ... U.S. ....., 102 S.Ct. 1760 (1982)	15
Horne v. New England Patriots Football Club, 489 F.Supp. 465 (D.Mass. 1980)	26
In re Wertheim & Co., Inc. v. Halpert, 48 N.Y.2d 681, 397 N.E.2d 386, 421 N.Y.S.2d 876 (1979)	27
International Ass'n of Heat and Frost Insulators and Asbestos Workers v. Leona Lee Corp., 434 F.2d 192 (5th Cir. 1970)	44
Iowa Beef Packers, Inc. v. Thompson, 405 U.S. 228 (1972) (per curiam)	6, 7
Johnson v. Louisiana, 406 U.S. 356 (1972)	41
Jordan v. County of Los Angeles, 669 F.2d 1311 (9th Cir. 1982)	48
Kiehne v. Purdy, 309 N.W.2d 60 (Minn. 1981)	28
Knouse v. Nimocks, 8 Cal.2d 482, 66 P.2d 438 (1931)	6
LaSala v. American Sav. & Loan Assn., 5 Cal.3d 864, 97 Cal.Rptr. 849, 489 P.2d 1113 (1971)	40
Lewis v. Curtis, 671 F.2d 779 (3d Cir. 1982)	48
Leyva v. Certified Growers of California, Ltd., 593 F.2d 857 (9th Cir.), cert. denied, 444 U.S. 827 (1979)	7, 9
Local 926 v. Jones, ... U.S. ....., 103 S.Ct. 1453 (1983)	21
Louisville N.R. Company v. Motley, 219 U.S. 467 (1911)	33
Machinists v. Wisconsin Employment Relations Comm'n., 427 U.S. 132 (1976)	21
Main v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 67 Cal.App.3d 19, 136 Cal.Rptr. 378 (1977)	32, 43

Table of Authorities Cited

Cases

Page

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Matter of Czarnikow-Rionda Co., Inc., 512 F.Supp. 1308 (S.D.N.Y. 1981) 44, 45

McGhee v. Bank of America, 60 Cal.App.3d 442, 131 Cal.Rptr. 482 (1976) 48

McKeiver v. Pennsylvania, 403 U.S. 528 (1971) 41

Melancon v. McKeithen, 345 F.Supp. 1025 (E.D.La. 1972), aff'd. mem., 409 U.S. 943 (1972), 409 U.S. 1098 (1973) 34, 37

Merrill Lynch, Pierce, Fenner & Smith v. Moore, 590 F.2d 823 (10th Cir. 1978) 26

Merrill Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117 (1973) ..... passim

Metro Industrial Painting Corp. v. Terminal Constr. Co., 287 F.2d 382 (2d Cir. 1961) 20, 24

Milani v. Conti Commodity Services, Inc., 462 F.Supp. 405 (N.D.Cal. 1976) 28

Milwaukee Typo. U. v. Newspapers, Inc., 639 F.2d 386 (7th Cir.), cert. denied, 454 U.S. 838 (1981) 44

Moseley v. Electronic Facilities, 374 U.S. 167 (1963) 32

Moses H. Cone Memorial Hospital v. Mercury Constr. Co., ... U.S. ...., 103 S.Ct. 927 (1983) ..... passim

Muh v. Newburger, Loeb & Co., 540 F.2d 970 (9th Cir. 1976) 25

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New York ex rel. Bryant v. Zimmerman, 278 U.S. 63 (1928) 11

Table of Authorities Cited

Cases

Page

North Dakota Pharmacy Board v. Snyder's Stores, 414 U.S. 156 (1973) 13

Northern Pipeline Co. v. Marathon Pipe Line, ... U.S. ....., 102 S.Ct. 2858 (1982) 36, 37

Pacific Gas & Elec. Co. v. State Energy Resources Cons. & Dev. Comm., ... U.S. ....., 103 S.Ct. 1713 (1983) 19

Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967) 23, 25

Ray v. Atlantic Richfield Co., 435 U.S. 151 (1978) 19

Republic Natural Gas Co. v. Oklahoma, 334 U.S. 62 (1948) 5

Richmond v. Dart Industries, Inc., 29 Cal.3d 462, 174 Cal.Rptr. 515, 629 P.2d 23 (1981) 46, 48

Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402 (2d Cir. 1959), cert. denied, 364 U.S. 801 (1960) 24, 25, 43

Robinson v. Warner, 370 F.Supp. 828 (D.R.I. 1974) 44

Romnes v. Bache & Co., 439 F.Supp. 833 (W.D. Wis. 1977) 30, 31

Runyan v. California, 439 U.S. 904 (1978) 16

San Diego Gas & Electric Co. v. San Diego, 450 U.S. 621 (1981) 6

Sandefer v. Reynolds Securities Inc., 618 P.2d 690 (Colo.App. 1980) 28

Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974) 32

Seaboard Coast Line R. Co. v. Trailer Train Co., 690 F.2d 1343 (11th Cir. 1982) 6

Senter v. General Motors Corp., 532 F.2d 511 (6th Cir. 1976) 48

TABLE OF AUTHORITIES CITED

CASES

	Page
Sibley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), rehearing denied, 547 F.2d 286, cert. denied, 434 U.S. 824 (1977)	15
State Ex. Rel. Geil v. Corcoran, 623 S.W.2d 557 (Mo. App. [illegible])	29
State ex rel. St. Joseph Light & Power Co. v. Donelson, 631 S.W.2d 887 (Mo.App. 1982)	29
Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593 (1960)	8
Stevenson v. Com. of Pennsylvania, Dept. of Revenue, 489 Pa. 1, 413 A.2d 667 (1980)	47
Street v. New York, 394 U.S. 576 (1969)	11
Supak & Sons Mfg. Co., Inc. v. Pervel Industries, Inc., 593 F.2d 135 (4th Cir. 1979)	14, 31
Teamsters Local 20 v. Morton, 377 U.S. 252 (1964)	21
Thayer v. American Financial Advisers, Inc., 322 N.W. 2d 599 (Minn. 1982)	28
U-Haul Co. v. Alabama State, 294 Ala. 685, 316 So.2d 685 (1975)	37
United Nuclear Corp. v. General Atomic Co., 93 N.M. 105, 597 P.2d 290, cert. denied, 444 U.S. 911 (1979)	28
United Steelworkers v. Warrior & Gulf Nav. Co., 363 U.S. 574 (1960)	8
U.S. Bulk Carriers v. Arguelles, 400 U.S. 351 (1971)	26
Vasquez v. Superior Court, 4 Cal.3d 800, 94 Cal.Rptr. 796, 484 P.2d 964 (1971)	40, 49
Veix v. Sixth Ward Building & Loan Association, 310 U.S. 32 (1940)	32
Vigo Steamship Corp. v. Marship Corp., 26 N.Y.2d 157, 309 N.Y.S.2d 165, 257 N.E.2d 624, cert. denied, 400 U.S. 819 (1970)	43
Webb v. Webb, 451 U.S. 493 (1981)	11

TABLE OF AUTHORITIES CITED

CASES

Page

Wilko v. Swan, 346 U.S. 427 (1953) 8, 9, 21, 27, 30, 34
Wineland v. Marketex Intern. Inc., 28 Wash. App. 830, 627 P.2d 967 (1981) 29
Zahn v. International Paper Co., 414 U.S. 291 (1973) 46

Constitutional Provisions

United States Constitution:
Article I, Section 8, Clause 3 (The Commerce Clause) .....passim
Article III, Section 1 34
Article VI, Clause 2 (The Supremacy Clause) .....passim
Tenth Amendment 35
California Constitution:
Article 6, Section 1 34

Statutes

California Code of Civil Procedure:
Section 1280 et seq. 42
Section 1281 31
Section 1281.3 12
Section 1285 et seq. 49
Section 1294.2 16
California Corporate Securities Law, Cal. Corp. Code Section 25701 .....18, 30
California Franchise Investment Law, Cal. Corp. Code Sections 31000-31516 .....passim
California Labor Code, Section 229 .....25, 29, 30
Federal Arbitration Act, 9 U.S.C. Sections 1-14 .....passim
Iowa Code Ann. Section 679A.1(2)(a) (West Supp. 1982) 41
28 U.S.C. 1257 13
Public Law No. 97-247 (1982) 27

TABLE OF AUTHORITIES CITED

Rules

	Page
American Arbitration Association Rules of Commercial Arbitration, Rule 23	48
Federal Rules of Civil Procedure:	
Rule 23	12, 45
Rule 42	12
Rule 42(a)	44, 45
Rule 81(a)	12, 42, 44, 45
Rules of the New York Stock Exchange:	
Rule 347(b)	20
Rule 612(c)(1)	44

Legislative Materials

Arbitration of Interstate Commercial Disputes:	
Joint Hearings on S. 1005 and H.R. 646 Before the Subcomms. of the Comms. on the Judiciary, 68 Cong., 1st Sess. (1924)	23, 24
65 Cong. Rec. 1,931 (1924)	23
H.R. Rep. No. 96, 68th Cong., 1st Sess. 17 (1924)	23, 24

Other Authorities

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3 A. Corbin, Corbin on Contracts (1960)	11
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6 B. Witkin, Cal. Procedure (2d Ed. 1971)	6
16 C. Wright & A. Miller, Federal Practice and Procedure (1977)	13

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BRIEF OF APPELLEES

STATEMENT OF THE CASE

All of the plaintiffs are California franchised operators of 7-Eleven convenience stores—the modern day corner grocery. The substantive rights sued upon are all governed by state law. In the state courts, Southland sought to compel arbitration under both the state and federal acts. The Federal Arbitration Act (hereinafter "FAA") was held applicable because Southland is located in Texas and the 7-Eleven chain bears a federally registered trademark.

Southland's "Questions Presented" mischaracterize the issues before this Court. The first question leaves out crucial language of the FAA denying the enforceability of arbitration clauses "upon such grounds as exist at law or in equity for the revocation of any contract." The California Supreme Court phrased the preemption issue more accurately: "[W]hether the principles of *'substantive federal law'* embodied in the FAA, preclude a state from protecting its franchise investors through a system of statutory regulation including nonwaivable judicial remedies." J.S. App. 14a-15a.[1]

Southland's statement of the second issue is likewise highly misleading. The California Supreme Court did not superimpose judicial class action procedures on a private arbitration. It remanded the action to the superior court to determine whether the possibility of class arbitration could save the arbitration clause in this adhesion contract from being declared unconscionable under general principles of California contract law. The California Supreme Court stated the matter as follows:

> One possible solution to this dilemma would be to hold that arbitration agreements contained in contracts of adhesion may not operate to stay properly maintain-

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[1]The following abbreviations are used herein: The Appendix to Southland's Jurisdictional Statement is cited as "J.S.App."; Southland's Jurisdictional Statement as "J.S."; the Joint Appendix as "Jt. App."; and Southland's Opening Brief as "Op. Br."

> able class actions . . . . The statutes and public policy supportive of arbitration, require, however, that this result be avoided if means are available to give expression to the basic arbitration commitment of the parties.

J.S.App. 25a-26a. The court found no theoretical barrier under California law to such procedure and ordered the trial court to consider classwide arbitration as one possible solution, leaving Southland the option of remaining in court if it so chose. J.S.App. 29a-30a.

The California Supreme Court's concern was well justified on the facts of this case. Southland attempts to disguise its motivation in moving to compel arbitration by falsely asserting that this action began with the filing of the *Keating* complaint in May of 1977, and that new and complex accounting issues were raised in *Keating* which caused Southland suddenly to abandon litigation in the courts for arbitration.[2] The truth is that the only difference between *Keating* and the other franchise actions Southland had been litigating for two years was that *Keating* sought classwide relief. Southland's sole motivation in moving to compel arbitration was to defeat the class action. The California Supreme Court's decision is not antiarbitration, it merely refuses to permit an adhesive arbitration provision to be used to shield a party with superior bargaining power from classwide accountability for classwide wrongs.

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[2]The accounting issue which Southland asserts as its reason for moving to arbitrate was first raised as one of the allegations of intentional misrepresentation in the 1975 *Gouveia* complaint. The issue was later amplified in the *Battersby* complaint which was filed three months *after* Southland made its motion to compel arbitration in *Keating*. Subsequently, in connection with a motion to coordinate, all of the franchisees amended their complaints to mirror the *Battersby* allegations. The allegations of the First Amended Complaint in *Keating* included in the joint appendix are typical of all the franchisees' amended complaints. Jt.App. 12-25. The coordination proceedings and amended pleadings affected the state court's determination of waiver, J.S.App. 21a-22a, but had nothing to do with Southland's original decision to seek arbitration.

SUMMARY OF THE ARGUMENT

I. Southland fails to demonstrate that this Court has jurisdiction over either of the issues presented for review. The question whether the FAA preempts the California Franchise Investment Law cannot be reached because it is outside the scope of the arbitration clause in Southland's standardized agreement. Second, whether California may consider a class arbitration proceeding was raised and decided as an issue of state law below. It cannot be presented here for the first time as a question of federal law. Third, the California Supreme Court's decision is not final.

The court remanded the action to the trial court for determination of whether a class should be certified and, if so, to explore the possibility of a class arbitration proceeding in order to save Southland's adhesive arbitration provision from being declared invalid under general principles of California contract law. Because of the presence of non-arbitrable classwide statutory claims, the trial court could exercise its equitable jurisdiction to entertain the entire class action in court. The uncertain posture of the case prevents meaningful review by this Court at this juncture. Nor is there any need for this Court to step in before further proceedings take place. The California court's directive on remand does not undermine any federal policy.

II. California has a longstanding policy like that of the federal government favoring the enforcement of arbitration agreements for common law disputes. But neither government considers this policy to mean that arbitration is a suitable forum for determining important statutory rights. The very same features which make arbitration desirable for resolving ordinary contract disputes make it an inappropriate forum for scrutiny of alleged unlawful conduct and vindication of important governmental policies.

Congress has allowed state law to operate vigorously in the area of franchise investment regulation. In passing California's Franchise Investment Law, the state legislature consciously adopted the very same anti-waiver pro-

vision which Congress found essential to the protection of investors covered by the federal securities acts. It is highly unlikely that Congress would have intended to cripple the effectiveness of such legislation by prohibiting investors' access to the courts to receive the protection guaranteed by the state legislature. An intent to preempt simply cannot be inferred where the state legislative scheme is modeled after a similar federal legislative scheme and furthers the same policies.

The FAA is restrictive in scope. It expressly defers to applicable state law on issues of validity. Under California law any contract provision which purports to waive compliance with the Franchise Investment Law is invalid and, thus, not within the coverage of the FAA. The Act cannot be interpreted otherwise.

It is an essential function of state courts to enforce important state policies. Under our federal system, congressional authority to control the forum for resolution of state-created rights is at a minimum. In enacting its own legislation, Congress has deemed numerous rights important enough to require access to the courts to ensure their effective implementation. An interpretation of the FAA to bar the states from implementing parallel policies in the same manner would serve no legitimate federal interest. If so interpreted, the FAA would be an unconstitutional exercise of congressional power under the Commerce Clause.

III. The California court's decision with respect to arbitration of the common law claims is not in conflict with the FAA. Applying general principles of contract law, the California court decided that the arbitration agreement in question, being part of an adhesion contract, is only valid if it does not operate to insulate Southland from a class remedy for classwide wrongs. It therefore authorized the trial court, on remand, to entertain a class motion and, if appropriate, to use its equitable powers to fashion a suitable procedure by means of a consolidated or class arbitration.

The FAA does not control state court procedures. Consolidation is often more complicated and intrusive to the basic agreement than a class procedure would be. Class arbitration would involve a representative franchisee litigating the same claim for all injured parties. It is far better than Southland's two alternatives: (1) numerous duplicative arbitration proceedings with potentially inconsistent results; or (2) only a few scattered arbitrations with those franchisees having enough at stake to arbitrate identical claims one-on-one with a franchisor of vastly superior economic resources. The former is far more costly and inefficient than a class arbitration; the latter would totally undermine the strong state policy in favor of classwide accountability for classwide wrongs. The California Supreme Court's attempt to equalize the parties while preserving the choice of forum is a laudable experiment in accommodating both the policy favoring arbitration and the policy favoring class actions.

ARGUMENT

I

THIS COURT DOES NOT HAVE JURISDICTION OVER THIS CASE

This Court has reserved the question of jurisdiction pending the hearing on the merits. Southland has the burden of affirmatively establishing jurisdiction on both of the issues presented. *Republic Natural Gas Co. v. Oklahoma*, 334 U.S. 62, 70-71 (1948). It fails to do so. First, as a threshold matter, this Court must determine whether Southland's arbitration clause is broad enough to include claims under the Franchise Investment Law. Second, the class arbitration issue was not raised as a federal question below. Third, the decision below is not a final judgment—numerous issues remain to be resolved by the trial court. Thus, appellees do not concede that this Court has jurisdiction over either issue presented by Southland.

A. The Arbitration Clause at Issue Does Not Include, Within Its Scope Statutory Claims Under the California Franchise Investment Law

Southland's preemption argument on the Franchise Investment Law claims cannot be reached unless those claims are within the scope of its standardized arbitration clause—an issue left undecided by the state court.[3] Arbitration is a matter of contract and a party may not be required to arbitrate a dispute it did not agree to arbitrate. *Atkinson v. Sinclair Refining Co.*, 370 U.S. 238, 241 (1962); *Seaboard Coast Line R. Co. v. Trailer Train Co.*, 690 F.2d 1343, 1348 (11th Cir. 1982). Whether the arbitration clause of a contract requires arbitration of a given dispute remains a matter of contract interpretation governed by standard principles of construction. *Atkinson v. Sinclair Refining Co.*, 370 U.S. at 241-242; *Fuller v. Guthrie*, 565 F.2d 259, 260-261 (2d Cir. 1977). The scope of an arbitration clause under the FAA is a question of federal law, *Moses H. Cone Memorial Hospital v. Mercury Constr. Co.*, ... U.S. ...., 103 S.Ct. 927, 941 (1983), just as the scope of an arbitration clause in a collective bargaining agreement is a question of federal law.

In *Iowa Beef Packers, Inc. v. Thompson*, 405 U.S. 228 (1972) (*per curiam*), this Court refused jurisdiction after interpreting the scope of an arbitration clause in a collective-bargaining agreement as being too narrow to include

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[3]It is improper to speak, as Southland does, Op. Br. 6, n. 4, of the California Supreme Court's leaving undisturbed the decision of the court of appeal in this regard. The effect of the supreme court's granting a hearing is to vacate the intermediate decision, which then becomes a nullity, of no force or effect, as though it never existed. *San Diego Gas & Electric Co. v. San Diego*, 450 U.S. 621, 628 (1981), *citing Knouse v. Nimocks*, 8 Cal.2d 482, 483-484, 66 P.2d 438, 438 (1931); *see generally*, 6 B. Witkin, Cal. Procedure, Appeal § 617 (2d Ed. 1971). Having vacated the court of appeal's decision, it left open the question whether the trial court correctly interpreted the clause as being too narrow to encompass the statutory claims. J.S.App. 8a-9a.

the issue presented by the petition for certiorari—whether a statutory claim for overtime wages under the Fair Labor Standards Act was subject to arbitration.[4] In *Leyva v. Certified Growers of California, Ltd.*, 593 F.2d 857 (9th Cir.), *cert. denied*, 444 U.S. 827 (1979), the court, relying in part on *Iowa Beef Packers*, also interpreted an arbitration clause not to include FLSA claims. In construing the contract, it noted that "contracts which provide for arbitration of contract disputes should not be read to require arbitration of statutory claims absent express provision for such arbitration. Here, not only is there no express provision for arbitration of statutory claims, there is . . . a strong indication of contrary intent." *Id.* at 863.

There is good reason for such a rule of construction. Arbitration has traditionally concerned the interpretation and performance of contracts, often in specialized fields, such as collective bargaining or construction contracts. Arbitrators, who are not necessarily lawyers, may be skilled in the particular field, but are not ordinarily expected to interpret and enforce complicated remedial legislation. These considerations have frequently impelled the courts to reject the contention that arbitrators have authority to apply statutory law. " 'The arbitrator has authority to resolve only questions of contractual rights, and this authority remains regardless of whether certain

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[4]The agreement at issue provided for arbitration of grievances "pertaining to a violation of the Agreement." The agreement covered both the employees' lunch period and overtime. The employees brought suit to recover overtime compensation under the Fair Labor Standards Act because they were required to remain on call during their lunch period. The Iowa Supreme Court had held that "the present controversy is undoubtedly arbitrable" under the agreement, but that access to a judicial forum to enforce employee claims under the Act was guaranteed by Congress irrespective of any private agreement to arbitrate. 185 N.W.2d 738, 741 (1971). Here, the California Supreme Court likewise decided the issue as one of statutory interpretation. In each case the question of scope is one which must be decided by this Court preliminary to reaching the issue of statutory interpretation.

contractual rights are similar to, or duplicative of, the substantive rights secured by [the statute].' " *Barrentine v. Arkansas-Best Freight System,* 450 U.S. 728, 744 n. 23 (1981), *quoting Alexander v. Gardner-Denver Co.,* 415 U.S. 36, 53-54 (1974). " 'If an arbitral decision is based "solely upon the arbitrator's view of the requirements of enacted legislation," rather than on an interpretation of the . . . agreement, the arbitrator has "exceeded the scope of the submission," and the award will not be enforced.' " *Id.* at 744, *quoting Steelworkers v. Enterprise Wheel & Car Corp.,* 363 U.S. 593, 597 (1960).

The policy against arbitration of statutory claims in labor cases does not detract from the arbitrator's "high degree of competence with respect to the vital role in implementing the federal policy favoring arbitration of labor disputes." *Alexander v. Gardner-Denver Co.,* 415 U.S. at 57 n. 18. It merely recognizes the arbitrator's limitations. The policy against arbitration of statutory claims applies with even greater force in the context of a commercial dispute under the FAA. In the organized labor context, arbitration is recognized as "part and parcel of the collective bargaining process itself." *United Steelworkers v. Warrior & Gulf Nav. Co.,* 363 U.S. 574, 578 (1960). "Courts and arbitration in the context of most commercial contracts are resorted to because there has been a breakdown in the working relationship of the parties. . . . But the grievance machinery under a collective bargaining agreement is at the very heart of the system of industrial self-government." *Id.* at 581. As a result, this Court has subjected alleged agreements to arbitrate commercial claims involving special statutory safeguards to far greater scrutiny than it generally applies to claims of arbitrability under collective-bargaining agreements. *Id.* at 578.

The FAA affords "an opportunity generally to secure prompt, economical and adequate solution of controversies through arbitration if the parties are willing to accept less

certainty of legally correct adjustment." *Wilko v. Swan*, 346 U.S. 427, 438 (1953). The diversion of such disputes from the courts also helps to relieve court congestion. The very same characteristics which make arbitration highly desirable as the forum of choice for resolution of common law disputes between parties of equal bargaining power make it inappropriate for resolution of important statutory rights of an economically disadvantaged party. See, *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 57 (1974); *Wilko v. Swan*, 346 U.S. 427, 438 (1953); *Merrill Lynch, Pierce, Fenner & Smith v. Ware*, 414 U.S. 117, 131-32 (1973). Arbitration is essentially a development of the common law which ill-serves the higher standards of protective legislation. *Cf. Herman & MacLean v. Huddleston*, ... U.S. ....., 103 S.Ct. 683 (1983) (rejecting traditional common law practices in establishing standard of proof in actions brought under section 10(b)(5) of the Securities Exchange Act of 1934).

As in the *Leyva* case, the Southland arbitration clause not only contains no express provision for arbitration of statutory claims, but it contains ". . . a strong indication of contrary intent." It begins with a general paragraph which provides that "[*u*]*nless prohibited by applicable law*, any controversy or claim arising out of or relating to this Agreement or the breach hereof shall be settled by arbitration . . . ." J.S. App. 49a n.2. (Italics supplied). This restrictive language does not appear in the standard American Arbitration Association clause, nor has exhaustive research revealed it to be discussed in any reported case. Its presence in the Southland agreement apparently was designed to exclude from arbitration any claims which require a judicial forum under applicable state law, in this case the Calfornia Franchise Investment Law.[5] The Fran-

[5]Southland may argue that it did not have state law in mind. The basic law applicable to the operation of these "Mom and Pop" grocery stores, however, is that of California. Indeed, all of the causes of action are predicated on substantive California law as are all of Southland's defenses. *See* Jt. App. 12-35. Nor can Southland

chise Investment Law claims have little to do with the agreement or its breach. They concern the alleged failure of Southland to comply with statutory disclosure requirements, requirements that apply *before* the parties enter into the franchise agreement. Subsection (i) provides that, "[t]he decision of the arbitrator within the scope of the submission . . . shall be final and binding on all parties, and *any right to judicial action on any matter subject to arbitration hereunder is hereby waived (unless otherwise provided by applicable law). . . .*" *Id.* at 50a n.2 (Italics supplied).

Other provisions of the arbitration clause also support that interpretation. The only remedy the arbitrators are expressly authorized to employ is damages sustained by *breach* of the *agreement. Id.,* Art. 35(g). Subsection (h) provides that, "the arbitrators shall not extend, modify or suspend any of the terms of this Agreement or the reasonable standards of business performance set by 7-Eleven in good faith." *Id.,* Art. 35(h). Thus, while the agreement allows the arbitrator no authority to grant damages other than for breach nor to suspend any terms of the agreement, the Franchise Investment Law specificially requires that plaintiffs be awarded damages caused by Southland's failure to make prepurchase disclosures or, if Southland's failure proves to be willful, recission. Cal. Corp. Code § 31300.[6]

The interaction of these clauses in the agreement leads to the conclusion that subsections (a) and (i) exclude

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reasonably contend that the restrictive language was only intended to exclude nonarbitrable state claims to the extent permitted by the FAA. There were no franchise decisions when these contracts were entered into that held state statutory rights of access to the court preempted by the FAA. Moreover, the scope of the submission is a question of intent. Resort to the FAA only brings the contract interpreter back to the language of the agreement.

[6]"Any person who offers or sells, a franchise in violation of Sections 31101, 31110, 31119, 31200, or 31202, shall be liable to the franchisee or subfranchisor, who may sue for damages caused thereby, and if such violation is willful, the franchisee may also sue

controversies which applicable law reserves to a judicial forum and that in recognition of that intent, subsections (g) and (h) limit the arbitrator's power to the enforcement of the parties' agreement by way of damages for its breach. Under settled rules of contractual interpretation, the specific language of Art. 35(g) operates to modify and nullify what might otherwise be a more general grant of authority contained in Art. 35(a). 3 A. Corbin, Corbin on Contracts § 547, at 176 (1960); *see* Restatement (Second) of Contracts § 203(c).

Southland's failure to include statutory claims within the scope of its arbitration clause precludes the jurisdiction of this Court over the question presented.

B. Southland Did Not Raise Class Arbitration As a Federal Issue in the Court Below

Where " 'the highest state court has failed to pass upon a federal question, it will be assumed that the omission was due to want of proper presentation in the state courts, unless the aggrieved party in this Court can affirmatively show the contrary.' " *Webb v. Webb*, 451 U.S. 493, 495 (1981), *quoting Street v. New York*, 394 U.S. 576, 582 (1969). The appellant must demonstrate that the federal claim and the ground therefor were brought to the attention of the state court with "fair precision and in due time." *New York ex rel. Bryant v. Zimmerman*, 278 U.S. 63, 67 (1928). Only where the record as a whole shows that this was done "either expressly or by clear intendment" is the claim adequately presented. *Id., see Durley v. Mayo*, 351 U.S. 277, 281 (1956).

Southland cannot point to any place in the record where the class arbitration issue was framed in terms of the

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for rescission, unless, in the case of a violation of Section 31200 or 31202, the defendant proves that the plaintiff knew the facts concerning the untruth or omission, or that the defendant exercised reasonable care and did not know, or, if he had exercised reasonable care, would not have known, of the untruth or omission." (Deering's Supp. 1983).

supremacy of federal law. Southland never contended at any level of the state court proceedings that state law was preempted by federal law on the class issue. In contrast to its argument on the Franchise Investment Law issue, Southland's many briefs on this point never used the word preemption or referred to the Supremacy Clause.

In the district court of appeal, Southland was explicitly asked whether federal law controlled the class arbitration issue. Southland responded that the issue was governed by state law.[7] In the supreme court, Southland cited state cases and the lack of state legislative authorization of class arbitration in arguing that California did not permit class arbitration. It repeatedly insisted that federal law apparently permitting the application of the federal class action rules to the FAA was unsound, and that California law, which in its view prohibited a class device, governed the issue.[8] *See* discussion in Motion to Dismiss at 5-6.

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[7]The clerk of the state court of appeal specifically asked the parties to address the question "[w]hether there can be arbitration of the class action. Please address the applicability, if any, of the California Code of Civil Procedure section 1281.3 and Federal Rules of Civil Procedure 81(a) and 23. Indicate in your answer *whether state* or *federal* law *applies* and the reason for your choice of law." (Italics supplied). Southland responded that California law applied. Supplemental Memorandum of Points & Authorities in Opposition to Petition for Writs of Mandate or Prohibition and Appellants' Reply Brief at 19-25.

[8]In the supreme court, Southland characterized the court of appeal's analogy to the application of Federal Rules of Civil Procedure 23 and 42 to arbitration proceedings under the FAA as "unsound." As Southland stated: "In the first place the Federal Rules of Civil Procedure are not applicable here. Under the *Erie* doctrine, state courts normally apply their own procedural rules in litigation involving a federal substantive right, provided such application does not impair the federal right. And under California law, there is an express statutory basis for *consolidating* separate arbitration claims, but there is no basis—statutory or otherwise—for compelling class action arbitration." Southland's Petition for Hearing at 24-25 (Italics in original). Thus, Southland expressly

As a result, the state courts decided the issue solely in terms of state law. An argument initially presented to the state courts in terms of state law cannot be shifted into a constitutional argument in order to gain review in this Court. 16 C. Wright & A. Miller, Federal Practice and Procedure § 4022 at 703 (1977); *see Bailey v. Anderson*, 326 U.S. 203, 205-207 (1945). Accordingly, Southland fails to meet the jurisdictional requirement that the federal issue be properly presented to the state courts.

C. There Is No Final Judgment

The final judgment rule serves to minimize federal intrusion in state affairs. *North Dakota Pharmacy Board v. Snyder's Stores*, 414 U.S. 156, 159 (1973). As Southland acknowledges, the decision below is not a final judgment conclusively determining the issues in the case. There will be further state court proceedings. Southland argues, however, that this case fits within that narrow category of exceptions allowing review of final determinations of federal issues which might "seriously erode" federal policy. *Cox Broadcasting Corp. v. Cohn*, 420 U.S. 469 (1975).[9]

These exceptions arose where the order appealed from was not subject to further modification or review. Where, however, the issues presented are unsettled, the case should be dismissed for lack of a final judgment. In

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negated any federal issue; rather, it relied upon the absence of any California authority for such a procedure. Indeed, in its reply brief before the supreme court, Southland argued that a class arbitration would be appropriate if there "were a serious and well-recognized need for class actions in this setting. But no such need has been identified by the *legislature*, by the courts, by the American Arbitration Association, or in the legal literature." Southland's Reply Brief in Answer to Petition for Hearing at 17. (Italics supplied). This is a clear reference to the California Legislature, not Congress.

[9] *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541 (1949), relied upon by Southland, has generally not been applied to cases arising under 28 U.S.C. § 1257. *But see, National Socialist Party v. Village of Skokie*, 432 U.S. 43 (1977).

Gillette v. Miner, ... U.S. ....., 103 S.Ct. 484 (1982), the petition for certiorari sought review of a state supreme court's remand to a trial court for consideration of certification of a nationwide class. In the proceedings below, the petitioner had argued that due process considerations precluded a nationwide class. The Illinois Supreme Court rejected petitioners' arguments and remanded for class certification proceedings. *See* 87 Ill. 2d 7, 428 N.E. 2d 478 (1981). This Court dismissed the petition for certiorari for lack of a final judgment.

Here, in contrast to *Cox*, further proceedings will occur which may very well change the complexion of the issues before this Court. As in *Gillette*, the California Supreme Court reversed the trial court's order and remanded for further consideration. The trial court had refused to conduct class certification proceedings before arbitration of plaintiffs' common law claims and had stayed litigation of plaintiffs' nonarbitrable statutory claims until the outcome of such arbitration. *See* J.S.App. 29a. The trial court must now decide whether the franchisees are a proper class, and if so, whether a class arbitration can be fashioned that will protect the class from the otherwise unconscionable effect of an arbitration clause placed in a standardized contract of adhesion. If the class cannot be protected, the whole arbitration clause may fall.[10] Moreover, since the

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[10]The validity of an arbitration agreement, as opposed to its scope, is a question of state law. *See, e.g., Supak & Sons Mfg. Co., Inc. v. Pervel Industries, Inc.*, 593 F.2d 135, 136-37 (4th Cir. 1979); *American Airlines, Inc. v. Louisville & Jefferson C.A.B.*, 269 F.2d 811, 816 (6th Cir. 1959); *Duplan Corp., etc. v. W. B. Davis Hosiery Mills*, 442 F.Supp. 86, 88 (S.D.N.Y. 1977). The California Supreme Court could have invalidated the arbitration clause under general contract principles because it was unconscionable and defeated the reasonable expectations of the nondrafting party if it blocked an otherwise appropriate class action. The court chose not to do so, however, because it viewed the class arbitration as providing the opportunity to redress classwide wrongs. J.S.App. 24a-26a.

common law claims may be arbitrable and the statutory claims are not, the trial court may decide that the interests of justice are best served by resolving the entire dispute in court, whether or not there is a class.[11] Absent such a determination, it must still decide which will proceed first—the arbitration or the court action.[12] It may decide that consolidation, which Southland asserts is an unsettled federal issue, may be proper; still other permutations may become apparent upon further proceedings below.

As a separate basis for urging that the class arbitration issue is final, Southland contends that it is appealing from the final disposition of an independent proceeding for a writ of prohibition. Thus, it argues a final judgment exists because a writ proceeding automatically results in such a judgment. Op. Br. 18 & n. 18.[13] This description mis-

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[11]When the presence of nonarbitrable claims prevents arbitration of the dispute as a whole, both federal and state courts have discretion to deny arbitration in order to prevent piecemeal, "inefficient and duplicative" resolution of claims or, more realistically, to avoid presenting plaintiffs with the Hobson's choice of dropping their common law claims to speed collection on their statutory claims or dropping their lawsuit "hoping for faster and cheaper results through arbitration." *Cunningham v. Dean Witter Reynolds*, 550 F.Supp. 578, 582, 584 n. 7 (E.D. Cal. 1982); *see Hope v. Superior Court*, 122 Cal.App.3d 147, 155, 175 Cal.Rptr. 851, 856-857 (1981), *cert. denied*, ... U.S. ...., 102 S.Ct. 1760 (1982).

[12]*See, e.g., Bos Material Handling, Inc. v. Crown Controls Corp.*, 137 Cal.App.3d 99, 111-12, 186 Cal.Rptr. 740, 747 (1982); *Sibley v. Tandy Corp.*, 543 F.2d 540, 543-544 (5th Cir. 1976), *rehearing denied*, 547 F.2d 286, *cert. denied*, 434 U.S. 824 (1977); *Dickenson v. Heinold Securities, Inc.*, 661 F.2d 638, 643-645 (7th Cir. 1981).

[13]In each of the cases cited by Southland for the proposition that a writ proceeding always results in a final judgment, Op. Br. 18, the party appealing to this Court was aggrieved by the denial of that party's claim that the lower courts were without jurisdiction to proceed. Here, Southland was aggrieved not by the denial of

characterizes the disposition of the issue by the California Supreme Court.

Southland's appeal from the trial court's initial order denying arbitration on the Franchise Investment Law claims had the effect of giving the state's appellate courts jurisdiction over all aspects of that order, including the order sending the common law claims to individual arbitration. *See* Cal. Civ. Proc. Code § 1294.2.[14] Therefore, the state supreme court had no need to, and did not, exercise its original jurisdiction under the writ to consider the class arbitration issue. Plaintiffs' petition for a writ of mandate or prohibition was denied.

As Southland recognizes, this Court compels a "practical" rather than mechanical approach to the question of finality. Op. Br. 12, 20. The fact that a decision below is rendered in connection with a writ proceeding is not dispositive of the issue of finality. *See Runyan v. California*, 439 U.S. 904 (1978) (appeal from order granting writ of prohibition dis-

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the writ of prohibition, which was the result it sought, but rather by the reversal of the order compelling individual arbitrations to proceed immediately on the common law claims. It is that reversal from which Southland now appeals.

[14]"The appeal shall be taken in the same manner as an appeal from an order or judgment in a civil action. Upon an appeal from any order or judgment under this title, the court may review the decision and any intermediate ruling, proceeding, order or decision which involves the merits or necessarily affects the order or judgment appealed from, or which substantially affects the rights of a party. The court may also on such appeal review any order on motion for a new trial. The respondent on the appeal, or party in whose favor the judgment or order was given may, without appealing from such judgment, request the court to and it may review any of the foregoing matters for the purpose of determining whether or not the appellant was prejudiced by the error or errors upon which he relies for reversal or modification of the judgment or order from which the appeal is taken. The provisions of this section do not authorize the court to review any decision or order from which an appeal might have been taken." Cal. Civ. Proc. Code § 1294.2.

missed for lack of final judgment). Such a practical approach is especially counseled here where further proceedings on these issues will definitely occur.

Moreover, neither issue presented by Southland raises federal questions which require immediate review because they might seriously erode federal policy, *Cox Broadcasting Corp v. Cohn, supra,* 420 U.S. at 483; both are matters limited to state concerns and state court dockets. Southland pins its claim to jurisdiction on the FAA, but that Act does not reach the issues presented. State protective legislation, such as the Franchise Investment Law, was never intended to, and does not, fall within the coverage of the Act. *See infra* at 22-27. Thus, there can be no serious erosion of a federal policy demanding immediate review before this Court.

Similarly, the class arbitration issue does not erode federal policy. The FAA does not usurp local court procedures which merely go to the method of enforcing arbitration.[15] The decision below favors arbitration even in the context of an adhesion contract by adopting a state court procedure calculated to reconcile arbitration and class actions. This procedure is solely a matter of local concern governing how the California courts should enforce arbitration in a particular type of adhesion contract.

Southland concedes that its appeal does not fit within traditional definitions of a final judgment. It thus attempts to fit the narrow exceptions defined in *Cox*. For the reasons stated above, the issues presented do not meet the criteria of these exceptional categories and, accordingly, there is no final judgment.

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[15] *See* discussion *infra* at 42-43.

II

THE FEDERAL ARBITRATION ACT DOES NOT AFFECT THE RIGHT OF A STATE TO SPECIFY A JUDICIAL FORUM FOR RESOLUTION OF STATUTORY CLAIMS*

The FAA was enacted to allow the federal courts to place arbitration agreements on the same footing as other contracts. Most of the states, including California, have adopted similar modern arbitration acts.[16] The FAA and parallel state acts merely permit parties to enforce predispute arbitration agreements. These acts were not intended to confer upon the parties to arbitration agreements the authority to override the states' traditional power to regulate the conduct of businesses operating within their borders.

This proposition is particularly true in the area of investor protection. Following the pattern set by federal prepurchase disclosure laws in the area of securities regulation, the California Legislature enacted the California Corporate Securities Law and the Franchise Investment Law. Both preserve an investor's access to the courts to ensure their effectiveness. J.S.App. 16a-17a.

Southland does not dispute the California Legislature's power to enact substantive law in these areas, or the enforceability of the right to a judicial forum for statutory claims involving purely intrastate disputes. But the reality of today is that almost everything affects interstate commerce. Thus, Southland asks this Court to destroy the effectiveness of California's (and other states') remedial legis-

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*The North American Securities Administrators Association, Inc. ("NASAA") has asked appellees to advise the Court that it joins in this part of the brief. NASAA is a regulatory association of securities regulators, including regulators from all 50 states.

[16]As of January 1, 1982, 42 states and the District of Columbia had adopted modern arbitration statutes. *See* Motion to Dismiss at 18 n. 14.

lation by declaring private agreements paramount to such laws. The state judiciary would be stripped of its constitutional duty to safeguard the statutory rights of investors whenever interstate franchisors have the foresight to place arbitration provisions in their standardized contracts. Fortunately, judicial extension of section 2 of the FAA to actions in state court does not entail such a harsh and illogical consequence. The Act simply does not delegate to private parties the power to control the forum for enforcement of important statutory rights.

A. An Intent to Preempt Cannot Be Inferred Where It Would Cripple the Exercise of State Police Power in a Substantive Area in Which Congress Has Intended State Law to Operate Vigorously

"[W]hen a State's exercise of police power is challenged under the Supremacy Clause, '[this Court] start[s] with the assumption that the historic police powers of the States [are] not to be superseded by [federal statutes] unless that was the *clear and manifest* purpose of Congress." *Ray v. Atlantic Richfield Co.*, 435 U.S. 151, 157 (1978) (italics supplied). Preemption is the exception, not the rule.[17] When respective federal and state sovereignties are juxtaposed, "the proper approach is to reconcile 'the operation of both statutory schemes with one another rather than holding one completely ousted.'" *Merrill Lynch, Pierce, Fenner & Smith v. Ware*, 414 U.S. 117, 127 (1973) (citations omitted). "[F]ederal regulation of a field of commerce should not be deemed preemptive of state regulatory power in the absence of persuasive reasons—either that the nature of the regulated subject matter permits no other conclusion, or that the Congress has unmistakably so ordained." *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963).

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[17]Even in areas of strong national concern, this Court is loath to find a congressional intent to preempt state regulation absent explicit preemptive language. *See, e.g., Pacific Gas & Elec. Co. v. State Energy Resources Cons. & Dev. Comm.*, ... U.S. ...., 103 S.Ct. 1713 (1983).

"[While] prior cases on preemption are not precise guidelines, [because] each case turns on the peculiarities and special features of the federal regulatory scheme in question,"[18] the *Ware* case presents a preemption issue very similar to the one here. The plaintiff, a former account executive, brought a class action in the California courts to recover benefits of a profit sharing plan forfeited upon termination of employment. The question presented to this Court was whether New York Stock Exchange Rule 347(b), requiring arbitration of all claims arising out of Exchange members' employment contracts, preempted California Labor Code provisions ensuring a judicial forum for wage claims. This Court, in a unanimous opinion (Stewart, J., not participating), held that California's strong policy in favor of providing a judicial forum for wage claims did not unduly burden interstate commerce or interfere with the fulfillment of the aims of the Securities Exchange Act. This Court further noted that California had a strong interest in protecting nonunionized wage earners from "what it regards as undesirable economic pressures affecting the employment relationship." 414 U.S. at 139.

In *Ware*, this Court concluded that congressional permission to establish the stock exchange's rule compelling arbitration was not intended to override otherwise applicable state law. The FAA is similar. It does not require arbitration of commercial disputes in interstate commerce; the Act merely permits the enforcement of otherwise valid agreements to arbitrate.[19] Indeed, the federal interest here

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[18] *City of Burbank v. Lockheed Air Terminal, Inc.*, 411 U.S. 624, 638-639 (1973).

[19] In enacting the Arbitration Act, unlike various other statutes invoking the interstate commerce power, Congress was not seeking to regulate and control activity affecting commerce, but was providing for those engaged in interstate transactions an expeditious extrajudicial process for settling disputes. The Arbitration Act may be avoided entirely by those engaged in interstate traffic if they merely refrain from including any arbitration provisions in their contracts." *Metro Industrial Painting Corp. v. Terminal Constr. Co.*, 287 F.2d 382, 387 (2d Cir. 1961) (Lumbard, C.J., concurring).

is less strong than in *Ware*. There, arbitration was pursuant to a Stock Exchange rule promulgated as part of a scheme for the self-regulation of an entire industry. The FAA is of general application. It does not purport to encroach upon the police powers of the state in any substantive field.[20]

Franchise investor regulation is not a field which Congress has preempted by pervasive federal regulation as it has a field such as organized labor relations. J.S.App. 17a.[21] Franchise regulation is an offshoot of securities regulation where state policies are expected to operate vigorously. *Merrill Lynch, Pierce, Fenner & Smith v. Ware, supra,* 414 U.S. at 140. In 1972, the California Legislature reacted to widespread abuse in the sale of California franchises by enacting a prepurchase disclosure law modeled after the 1933 Securities Act. J.S.App. 10a. Like the federal act, it was designed to remedy the disadvantages under which prospective purchasers labored in investigating and evaluating prospective earnings, and thus created a cause of action independent of the common law. *See* Cal. Corp. Code § 31001;[22] *Wilko v. Swan,* 346 U.S. 427, 435 (1953). Like

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[20]Congressional prohibition of the exercise of state police power in favor of the free play of economic forces can only be inferred where there is a comprehensive federal scheme encompassing the subject matter. *Machinists v. Wisconsin Employment Relations Comm'n.*, 427 U.S. 132, 140 (1976); *Teamsters Local 20 v. Morton,* 377 U.S. 252, 260 (1964).

[21]Indeed, even the "comprehensive amalgam of substantive law and regulatory arrangements that Congress set up in the NLRA" does not preempt any and all state causes of action involving the same subject matter. This Court repeatedly has upheld state causes of action against a claim that they were preempted by the NLRA, "[w]hen the conduct at issue is only a peripheral concern of the Act or touches on interests . . . deeply rooted in local feeling and responsibility." *Local 926 v. Jones,* .... U.S. ...., 103 S.Ct. 1453, 1459 (1983) and cases cited therein.

[22]"The Legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems both from an investment and a business point of view in the State of California. . . . California franchisees

that Act, it created a nonwaivable private right of action. J.S.App. 9a-13a.

Just as the general federal policy favoring arbitration has not prevented Congress from including an antiwaiver provision in federal investor protection legislation, California's general policy favoring arbitration has not prevented the California Legislature from including an antiwaiver provision in state investor protection legislation. That a different result should be compelled because the antiwaiver provision applies to a contract affecting interstate commerce makes no sense. As the California Supreme Court observed, "[h]aving left states with power to enact laws in this area, it is hardly likely that Congress intended to preclude them from adopting policies which Congress itself has found to be appropriate." J.S.App. 17a. Nothing in the history or purpose of the FAA suggests a congressional intent to treat state remedial legislation on a different footing from federal remedial legislation.

B. Congress Did Not Intend to Include Either State or Federal Statutory Claims Within the Coverage of the Act

With any consideration of statutory construction, consideration "begins, as indeed it must, with the text and legislative history . . . ." *Busic v. United States*, 446 U.S. 398, 405 (1980).

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have suffered substantial losses where the franchisor or his representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.

It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship."

The record is clear that Congress intended the FAA merely to overcome traditional judicial hostility to arbitration by placing such agreements "upon the same footing as other contracts" in the federal courts. H.R.Rep. No. 96, 68th Cong., 1st Sess. 1 (1924). It did not involve any new principle of law or create any new rights.[23] The Act provides a procedural device[24] in "the courts of the United States" applicable to "any maritime transaction or a contract evidencing a transaction involving commerce." 9 U.S.C. §§ 2, 3.

Congress acted primarily under its powers to "prescribe how federal courts are to conduct themselves with respect to subject matter over which Congress plainly has power to legislate." *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 (1967). The Act was plainly not intended to impose any restrictions on the states.[25]

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[23]In explaining the bill in the House of Representatives, one of its proponents stated:

> "This bill simply provides for one thing, and that is to give an opportunity to enforce an agreement in commercial contracts and admiralty contracts—an agreement to arbitrate, when voluntarily placed in the document by the parties to it. It does not involve any new principle of law except to provide a simple method by which the parties may be brought before the court in order to give enforcement to that to which they have already agreed. . . . It creates no new legislation, grants no new rights, except a remedy to enforce an agreement in commercial contracts and in admiralty contracts." 65 *Cong. Rec.* 1,931 (1924) (Rep. Graham, Pa.)

[24]"A Federal statute providing for the enforcement of arbitration agreements does relate solely to procedure of the Federal courts. It is no infringement upon the right of each state to decide for itself what contract shall or shall not exist." 11 A.B.A.J. 153, 154 (1925).

[25]As explained by the drafters in addressing the 1924 Congress: "[t]he theory on which you do this is that you have the right to tell the federal courts how to proceed." Joint Hearings on S. 1005 and H.R. 646 Before the Subcomms. of the Comms. on the Judi-

It was not until 35 years after passage of the Act that the courts developed the concept that there were certain substantive aspects to the FAA applicable in state as well as federal courts. *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959), *cert. denied*, 364 U.S. 801 (1960). This judicial finding that the Act contained substantive aspects resulted from a perception that the *Erie* doctrine would prohibit the federal courts from applying the Act in diversity cases.[26] Nevertheless, one of the justices who decided *Robert Lawrence* counseled that caution must be exercised so as to construe this intrusion upon state sovereignty as narrowly as possible:

> [T]he legislative history of the Arbitration Act of 1925 reveals little awareness on the part of Congress that state law might be affected . . . . Having no clear mandate from Congress as to the extent to which state statutes and decisions are to be superseded, we must be cautious in construing the act lest we excessively encroach on the powers which Congressional policy, if not the Constitution, would reserve to the states.

Metro Industrial Painting Corp. v. Terminal Constr. Co., 287 F.2d 382, 386 (2d Cir. 1961) (Lumbard, C. J., concurring).

In *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, ... U.S. ....., 103 S.Ct. 927 (1983), this

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ciary, 68th Cong., 1st Sess. 17 (1924), Statement of Julius Cohen. "Nor can it be said that the Congress of the United States, directing its own courts . . . , would infringe upon the provinces or prerogatives of the States. . . . [T]he question of enforcement relates to the law of remedies and not to substantive law. The rule must be changed for the jurisdiction in which the agreement is sought to be enforced . . . . *There is no disposition therefore by means of the Federal bludgeon to force an individual State into an unwilling submission to arbitration enforcement.*" *Id.* at 39-40 (italics supplied).

[26] *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, *supra*, 271 F.2d 402, 404-409.

Court has now declared, "The effect of [section 2] is to create a body of federal substantive law of arbitrability, applicable to any arbitration agreement *within the coverage of the Act.*" *Id.*, at ....., 103 S.Ct. at 941 (italics supplied). That case, like *Prima Paint* and *Robert Lawrence*, dealt solely with a common law dispute, not one involving a remedial statute.

In the present case, the California Supreme Court applied section 2 of the FAA to plaintiffs' common law claims since the agreement to arbitrate such claims fell "within the coverage of the Act." A separate issue, which this Court has never addressed,[27] was raised as to the arbitrability of plaintiffs' statutory claims—claims which Congress plainly never envisioned to be "within the coverage of the Act."

The drafters of the FAA expected the Act to apply solely to ordinary contract disputes "between merchants as to questions of fact—quantity, quality, time of delivery, compliance with terms of payment, excuses for nonperformance, and the like," involving simple issues of law. Cohen & Dayton, *The New Federal Arbitration Law*, 12 Va.L.Rev. 265, 281 (1926). "[*Arbitration*] *is not the proper method of deciding points of law of major importance involving constitutional questions or policy in the application of statutes.*" *Id.* (italics supplied).

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[27] Although the petitioner in *Ware* argued that the FAA also preempted the California Labor Code, Brief for Petitioner at 25-27, this Court did not reach that question and decided only that the Exchange's self-governing provisions promulgated pursuant to 15 U.S.C. § 78 did not preempt the California statute. Why this issue was not reached is unclear. *See* discussion in Motion to Dismiss at 23-24. The most likely explanation is that this Court concluded that application of the FAA would not have affected the preemption analysis. *See Muh v. Newburger, Loeb & Co.*, 540 F.2d 970, 973 (9th Cir. 1976), where the court assumed that *Ware* applied with equal force to an argument that California Labor Code section 229 was preempted by the FAA. Arbitration was nonetheless compelled in *Muh* because the plaintiff did not have a true wage claim under the California statute.

Thus, the drafters themselves recognized that arbitration is not a suitable means for dealing with important statutory rights. In *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974), this Court made the same observation in unanimously upholding an employee's right to litigate employment discrimination claims under Title VII of the Civil Rights Act of 1964 after unsuccessfully arbitrating the same set of facts as a contract claim under a collective bargaining agreement. "Both rights have legally independent origins and are equally available to the aggrieved employee." *Id.* at 52. This Court went on to explain: "Parties usually choose an arbitrator because they trust his knowledge and judgment concerning the demands and norms of industrial relations. On the other hand, the resolution of statutory or constitutional issues is a primary responsibility of courts. . . ." *Id.* at 57.

Over the years, this Court and the lower federal courts have recognized the need for a judicial forum to ensure full scrutiny of a variety of important rights which also happen to rest on operative facts ostensibly arbitrable under a contract.[28] These decisions recognize the unsuit-

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[28] *See, e.g., U.S. Bulk Carriers v. Arguelles*, 400 U.S. 351 (1971) (seaman's wage claim under 46 U.S.C. § 596 *et seq.* nonarbitrable); *Barrentine v. Arkansas-Best Freight System*, 450 U.S. 728 (1981) (claim for minimum wages under FLSA nonarbitrable); *Merrill Lynch, Pierce, Fenner & Smith v. Moore*, 590 F.2d 823 (10th Cir. 1978) (claims under Securities Act of 1933 and Securities Exchange Act of 1934 nonarbitrable); *Allegaert v. Perot*, 548 F.2d 432 (2d Cir.), *cert. denied* 432 U.S. 910 (1977) (claims brought against trustee in bankruptcy nonarbitrable); *American Safety Equipment Corp. v. J. P. Maguire & Co.*, 391 F.2d 821 (2d Cir. 1968) (claims brought under Sherman Antitrust Act nonarbitrable); *A & E Plastik Pak Co. v. Monsanto Co.*, 396 F.2d 710 (9th Cir. 1968) (same); *Curran v. Merrill Lynch, Pierce, Fenner & Smith*, 622 F.2d 216 (6th Cir. 1980) *aff'd* .... U.S. ...., 102 S.Ct. 1825 (1982) (claims brought uder Commodity Exchange Act nonarbitrable except in certain limited circumstances); *Breyer v. First National Monetary Corp.*, 548 F.Supp. 955 (D.N.J. 1982) (same); *Horne v. New England Patriots Football Club*, 489 F.Supp. 465 (D.Mass. 1980) (age discrimination claims brought under 29 U.S.C. § 621 non-

ability of arbitration as a means of resolving important statutory rights which are imbued with a public, and not just private, interest—an observation first made by this Court in *Wilko v. Swan*, 346 U.S. 417, 435-437 (1953).

There is no question that the decision of claims by arbitrators rather than the courts radically affects a cause of action. It removes numerous guarantees available to litigants in a court of law as a trade-off for parties seeking an informal resolution of private disputes. *Id.* at 435-438; *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198, 203 (1956); *Alexander v. Gardner-Denver Co., supra*, 415 U.S. at 57. This is why a predispute arbitration agreement between parties of unequal bargaining power has generally been held unenforceable under federal law wherever important rights are involved. That same advance trade-off is just as unacceptable where important state-created rights are concerned.

C. Parallel State Arbitration Acts Also Exclude from Arbitration Important Statutory Claims for which Access to the Courts Is Deemed Essential

The Federal Arbitration Act of 1924 was modeled after the New York arbitration law. Under New York law, [a]lthough arbitration is a favored method of dispute resolution, arbitration agreements are unenforceable where substantive rights, embodied by statute, express a strong public policy which must be judicially enforced." *In re Wertheim & Co., Inc. v. Halpert*, 48 N.Y.2d 681, 683, 397 N.E.2d 386, 387, 421 N.Y.S.2d 876, 877 (1979). *See* cases cited at J.S.App. 16a. California was also among the earliest states to adopt a modern arbitration statute. Now

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arbitrable). Until recently, courts had also interpreted the patent and trademark laws as requiring judicial enforcement—a practice which was consistent with prior law but which has now been superseded by congressional directive in enacting the patent and trademark appropriations bill for 1983-85. Pub. L. No. 97-247 (1982). Significantly, Congress has left untouched the judicial construction of its intent in the area of securities litigation, bankruptcy and antitrust.

the vast majority of the states have enacted similar legislation.

The state courts have followed the same reasoning as the federal courts in determining whether to enforce arbitration agreements arising under their own statutory schemes. They first determine whether the arbitration agreement is valid under general principles of contract law. Then they look to whether the claim arose from the common law and is covered by the liberal policy favoring arbitration or, if a statutory claim, whether the state legislature intended its enforcement to be reserved to the courts.[29] When the Federal Arbitration Act assertedly applies, the analysis should be the same.[30] Thus, the crucial question is whether the state legislature made access to a judicial forum essential to the enforcement of the particular legislation in question.

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[29]*See, e.g., Kiehne v. Purdy*, 309 N.W.2d 60 (Minn. 1981) (state securities law claims not arbitrable), *Sandefer v. Reynolds Securities Inc.*, 618 P.2d 690 (Colo.App. 1980) (same); *United Nuclear Corp. v. General Atomic Co.*, 93 N.M. 105, 597 P.2d 290, *cert. denied*, 444 U.S. 911 (1979) (state antitrust law claim not arbitrable); *Aimcee Wholesale Corp. v. Tomar Products Inc.*, 21 N.Y.2d 621, 237 N.E.2d 223, 289 N.Y.S.2d 968 (1968) (same); *Bos Material Handling, Inc. v. Crown Controls Corp.*, 137 Cal.App.3d 99, 186 Cal.Rptr. 740 (1982) (same); *Durst v. Abrash*, 22 A.D.2d 39, 253 N.Y.S.2d 351 (1964) (issue of whether transaction was disguised usurious loan not arbitrable).

[30]Differences still exist between state and federal law. In cases involving common law claims in interstate commerce where the state policy is not strong, the federal policy favoring arbitration under the FAA prevails. *See* cases cited in Motion to Dismiss at 18-19. There are also a few states still holding the FAA inapplicable in state court. *See Thayer v. American Financial Advisers, Inc.*, 322 N.W.2d 599 (Minn. 1982). Although *Moses H. Cone Memorial Hospital* would now render the FAA applicable, the outcome in *Thayer* would not necessarily change. This is because Thayer's primary claims arose under the Commodity Exchange Act. *See Milani v. Conti Commodity Services, Inc.*, 462 F.Supp. 405 (N.D.Cal. 1976) (refusing to compel arbitration of state law claims arising out of the same transaction as nonarbitrable claims under the Commodity Exchange Act).

In *Allison v. Medicab International, Inc.*, 92 Wash.2d 199, 597 P.2d 380 (1979), cited by Southland, the court found insufficient evidence of a legislative intent to void predispute arbitration agreements under Washington's franchise law. The possibility of preemption was advanced as a further reason to infer that the legislature did not intend to void such agreements. Southland mistakenly relies on this decision as supporting its position that the FAA utterly prevents state legislatures from voiding advance agreements to arbitrate statutory claims. It does not. Where a legislative intent to void predispute agreements under Washington's Consumer Protection Act was found, the Washington appellate court proceeded to uphold the legislation in the face of a claim that it was preempted by the FAA. *Wineland v. Marketex Intern. Inc.*, 28 Wash. App. 830, 627 P.2d 967 (1981).

Missouri likewise enforces the FAA with respect to common law claims. *State ex rel. St. Joseph Light & Power Co. v. Donelson*, 631 S.W.2d 887 (Mo.App. 1982), but has refused to order arbitration requested under both federal and state arbitration acts where violations of state securities laws were alleged because of Missouri's "very strong policy in favor of providing a judicial forum for the claims of investors under the blue sky laws." *State Ex. Rel. Geil v. Corcoran*, 623 S.W.2d 557, 559 (Mo.App. 1981).

This Court applied a similar analysis in reviewing the state wage law in *Ware*. It noted that the California Legislature "had in mind the rights accorded wage earners by § 229" as well as the "historical friendliness of California to the institution of arbitration" when it revised the California Arbitration Act. Section 229 survived subsequent legislative review and manifested itself as an important state policy. 414 U.S. 117, 132-133. This Court concluded that the California Legislature felt that "individual, nonunion, and otherwise unprotected" wage earners would receive "less than adequate protection" if relegated to arbitration. *Id.* at 131.

Similar legislative concern for preservation of access to the courts evidences itself in the antiwaiver provisions of the California Franchise Investment Law and the California Corporate Securities Law, Cal. Corp. Code §§ 31512, 25701,[31] patterned after antiwaiver provisions in the federal securities laws. J.S. pp. 16a-17a & n.13. The antiwaiver provision of the California Franchise Investment Law, like Labor Code section 229, has gone through subsequent legislative scrutiny and also emerged as an important state policy through interpretation by the California courts. J.S. App. 11a-13a.[32]

Southland cannot reargue here the California Supreme Court's conclusion that the California Legislature intended its use of the antiwaiver language of the 1933 Securities Act to be given the same interpretation as the federal law was given in *Wilko*. That is purely a question of state law beyond the scope of review by this Court. *Ware, supra,* 414 U.S. 117, 133 (1973). Nor does it argue that the FAA has been judicially construed to encompass federal statutory claims as well as contractual claims. Rather, it contends that the application of the supremacy clause provides a Catch-22 which prevents states from adopting a legislative scheme, parallel to that of Congress, whenever interstate commerce is affected by state protective legislation.[33]

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[31]Cal.Corp.Code § 31512 is set forth in Op.Br. at 3. Cal.Corp. Code § 25701 provides: "Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law or any rule or order hereunder is void."

[32]Indeed, similar concerns have led various states enacting protective legislation to borrow the identical antiwaiver language in *Wilko* to ensure that there would be no mistake about their intent to prescribe a judicial forum for resolution of the claims they were creating. *See* Motion to Dismiss at 15 n. 8.

[33]The Federal district court cases cited by Southland in support of this proposition are of no persuasive value. The principal ones arose out of Wisconsin—*Romnes v. Bache & Co.*, 439 F.Supp. 833 (W.D. Wis. 1977) and *Barron v. Tastee Freez International, Inc.*, 482 F.Supp. 1213 (E.D. Wis. 1980) both decided by Judge Reyn-

D. The Federal Arbitration Act Defers to State Law on Issues of Validity such as the Antiwaiver Provision of the Franchise Investment Law

Section 2 of the Act requires courts to look to state contract laws to determine the validity of arbitration agreements within the ambit of the Act. *American Airlines, Inc. v. Louisville & Jefferson C.A.B.*, 269 F.2d 811, 816 (6th Cir. 1959); *Supak & Sons Mfg. Co. v. Pervel Industries, Inc.*, 593 F.2d 135, 136-37 (4th Cir. 1979). The liberal federal policy behind section 2, like that of California Code of Civil Procedure Section 1281, only comes into play *after* a valid agreement to arbitrate has been found under applicable state law. "By its terms, § 2 does not apply until the arbitration clause in question is determined to be part of the contract. Section 2 dictates the *effect* of a contractually agreed-upon arbitration provision, but it does not displace state law on the general principles governing *formation* of the contract itself." *Supak & Sons Mfg. Co., Inc. v. Pervel Industries, Inc., supra*, 593 F.2d at 137 (italics supplied). Thus, the Act has been construed to defer to state law on the parties' capacity[34] on the issues of fraud or undue in-

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olds, and *Bache Halsey Stuart Shields, Inc. v. Moebius*, 531 F.Supp. 75 (E.D. Wis. 1982) decided by Judge Gordon. *See* discussion Motion to Dismiss at 16 n. 10. *Romnes* involved claims under the Commodity Exchange Act which has been interpreted to bar similar advance agreements to arbitrate. *See, supra*, at 27-28 nn. 28 & 30. *Moebius* involved an employment dispute nonarbitrable under Wisconsin law. The issue in *Moebius* may well have been governed by this Court's analysis in *Ware*, the applicability of which was apparently not raised by the parties. *Barron* involved the interaction between antiwaiver provisions in the Wisconsin and Illinois franchise investment acts and the FAA. The decision was devoid of any reasoning in support of the judge's conclusion that he was "compelled" under principles of preemption "to render void any effort made by a state to protect the remedies of franchise investors. . . ." 482 F.Supp. at 1217.

[34] *American Airlines, Inc. v. Louisville & Jefferson C.A.B.*, 269 F.2d 811 (6th Cir. 1959) (holding that Kentucky law controlled the question of the capacity of a municipal corporation to enter into an arbitration agreement).

fluence in the inducement[35] and other issues of contract formation.

No contract is valid if it is unlawful. The specific law applicable here is the California Franchise Investment Law, a statutory scheme designed in large part to combat franchisor fraud. *See* Cal.Corp.Code § 31001, *supra* at 21-22 n. 22. Any provision in a franchise contract which purports to waive compliance with any provision of the Franchise Investment Law is void. Cal. Corp. Code § 31512. In the state courts Southland argued that the antiwaiver statute was not intended to have any effect upon agreements to arbitrate statutory claims.[36] Now it contends that the statute is anti-arbitration. Neither is true. The Franchise Investment Law requires access to a judicial forum for vindication of the rights which it provides franchise investors. An agreement to arbitrate future disputes under the Franchise Investment Law has been definitively construed as a prohibited waiver of that statutory provision. This rule does not treat arbitration agreements differently from any other contracts which purport to waive compliance with the Franchise Investment Law.

The FAA only makes arbitration agreements as enforceable as other agreements. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1974). It is firmly established that the right to contract is subject to the paramount authority of the state to safeguard the vital interests of its people. *Veix v. Sixth Ward Building & Loan Association*, 310 U.S. 32, 38-39 (1940). The authority of a state legislature in the exercise of its police powers cannot be limited or restricted by the provisions of private contracts between an individual and a corporation. *Dillingham v. McLaughlin*, 264 U.S. 370, 374 (1924). If the rule were to the contrary, the most im-

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[35] *Comprehensive Merch. Cat., Inc. v. Madison Sales Corp.*, 521 F.2d 1210 (7th Cir. 1975), *citing Moseley v. Electronic Facilities*, 374 U.S. 167 (1963); *Main v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 67 Cal.App.3d 19, 136 Cal.Rptr. 378 (1977).

[36] *See* Reply Brief to Answer to Petition for Hearing in the Cal. Supreme Court at 2-8.

portant and valuable reforms could be precluded by the simple device of entering into contracts for the purpose of doing that which was otherwise prohibited. *Louisville N.R. Company v. Motley,* 219 U.S. 467, 482 (1911).

If Southland's arbitration clause were upheld in the face of California's antiwaiver statute, it would be singled out for special sanction unavailable to any other provision or stipulation purporting to waive compliance with the Franchise Investment Law. The FAA by its terms does not require such a result, nor is the policy favoring arbitration furthered by allowing corporations to shield allegedly unlawful conduct from full judicial scrutiny. Indeed, Southland's strained interpretation of that Act to prohibit judicial enforcement of state franchise legislation raises serious constitutional questions.

E. The Federal Arbitration Act Would Be Unconstitutional If Applied to Bar State Courts from Adjudicating Important State Rights for which Access to a Judicial Forum Is Guaranteed by the State Legislature

The determination that the FAA does *not* preempt antiwaiver provisions in state legislation such as the California Franchise Investment Law is further compelled by the rule requiring that statutes be interpreted to avoid possible unconstitutionality. *Alabama State Federation of Labor v. McAdory,* 325 U.S. 450, 470 (1945). Southland contends that Congress has used a general procedural statute to confer upon private parties the power to veto state protective legislation. According to Southland, regardless of the state interest involved, Congress has declared that it is up to target corporations to decide whether their alleged unlawful practices are to be "muffl[ed] in the cloakroom of arbitration"[37] rather than subjected to public airing and full judicial scrutiny. As stated above, the history and purpose of the FAA support no such construction. Nonetheless, assuming arguendo that Congress did have such intent,

[37] *Merrill Lynch, Pierce, Fenner & Smith v. Ware,* 414 U.S. 117, 138 (1973).

this Court would have to declare such application of the Act to be unconstitutional.

In creating a private right of action as part of protective legislation, Congress relies on the judiciary as its sister branch to enforce the rights and remedies specified therein and thus vindicate the important congressional policy embodied in such legislation. *See, e.g., Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 45 (1974); *Wilko v. Swan*, 346 U.S. 427, 436-437 (1953). Just as Article III, Section 1 of the Constitution confers the judicial power of the United States upon the federal courts, so Article 6, Section 1 of the California Constitution confers the judicial power of the State of California upon the state courts. Important federal rights are identified by Congress and this Court; important state rights are identified by state legislatures and state courts. The California Legislature likewise relies on its courts to adjudicate private rights of action which it has created to enforce important state concerns.

While state law generally must be subordinated to paramount legislation of national concerns, state control of purely state matters is supreme.[38] The procedure by which state rights may be enforced and wrongs remedied is also "peculiarly a subject of state regulation and control."[39] State courts are the only courts with unlimited jurisdiction over state claims. Under our federal system, the federal courts also may hear state claims if the requisites for diversity jurisdiction are met or if the state claims are pendent to federal claims. In both situations, the fed-

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[38]"Except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the State. And whether the law of the State shall be declared by its Legislature in a statute or by its highest court in a decision is not a matter of federal concern." *Erie R. Co. v. Tompkins*, 304 U.S. 64, 78 (1938).

[39]*Melancon v. McKeithen*, 345 F.Supp. 1025, 1044 (E.D.La. 1972), *aff'd. mem.*, 409 U.S. 943 (1972), 409 U.S. 1098 (1973), *quoting Hardware Dealers Mutual Fire Insurance Company v. Cladden*, 284 U.S. 151 (1931).

eral courts attempt to discern applicable state law, looking to the state supreme court for the final word on state issues,[40] sometimes staying the action in federal court pending resolution of crucial state issues by the state courts.[41]

These policies derive from principles of federalism grounded in the Constitution. *Erie R. Co. v. Tompkins,* 304 U.S. 64, 78 (1938). The Tenth Amendment imposes an affirmative constraint upon Congress' commerce powers. It ensures that the " 'separate and independent existence of the states' . . . not be lost through undue federal interference in certain core state functions." *Equal Employment Opportunity Commission v. Wyoming,* ..... U.S. ....., 103 S.Ct. 1054, 1060 (1983).

In contrast to that case, there is no issue here as to whether the state's police power has been preempted by a national legislative scheme developed in response to severe nationwide problems such as those created by discriminatory retirement practices. The state's power to enact legislation regulating the subject matter of franchise investments is conceded; it is solely the power to enforce such legislation which allegedly has been preempted.

Promoting arbitration of common law claims under the FAA provides relief to federal dockets by consensual removal of cases involving little or no public interest. This frees the federal courts to focus on enforcing important statutory and constitutional rights. Consistency is assured by having state courts apply the FAA to common law claims in interstate commerce. This construction of the Act is reasonable. But Southland contends that Congress went much further and relegated all state issues to arbitration regardless of their origin and importance. What federal interest is served by declaring that all state rights

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[40] *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware,* 414 U.S. 117, 133 (1973).

[41] *See, e.g., American Airlines, Inc. v. Louisville & Jefferson C.A.B.,* 269 F.2d 811, 827 (6th Cir. 1959).

are adequately protected in an arbitral forum when Congress has found that forum unacceptable for important rights of its own creation?

Indeed, the choice of forum to adjudicate rights not created by Congress is generally not subject to Congress' power to regulate. Thus, in *Northern Pipeline Co. v. Marathon Pipe Line,* ..... U.S. ....., 102 S.Ct. 2858 (1982), this Court held unconstitutional Congress' grant of authority to bankruptcy courts to hear claims arising under state law. It held that congressional power to intrude upon the province of the constitutional courts is at "a minimum" when it seeks "to control the manner in which [a right under state law] is adjudicated." *Id.* at ....., 102 S.Ct. at 2878.

Compelling arbitration of state-created claims which are nonarbitrable under state law likewise appears beyond congressional power.[42] This designation of a body other than a constitutional court to hear and decide cases does not fit within proper categories of legislative courts recognized by the plurality in *Marathon.* Neither would such arrogation of judicial power survive the balancing test of the *Marathon* dissent. Like the appellants in *Marathon,* Southland provides no limiting principle. It threatens complete denial of access to state courts for adjudication of state-created rights whenever a private corporation engaged in interstate commerce chooses to insert an arbitration provision in its contract.

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[42]The constitutional question cannot be avoided by reference to the parties' agreement. The California Legislature defined the cause of action to survive any attempt to waive in advance the franchise investor's right to litigate in court. The parties' agreement by itself could not override this exercise of state police power. *See supra* at 32-33. Only the imprimatur of Congress could render the agreement preemptive of the legislative choice of forum.

Denial of the right of access to the courts for consideration of important rights also raises questions of due process. "Under certain circumstances, the constitutional requirement of due process is a requirement of judicial process." *Northern Pipeline Co. v. Marathon Pipe Line*, ... U.S. at ....., 102 S.Ct. at 2877 n. 33, *quoting Crowell v. Benson*, 285 U.S. 22, 87 (1932) (Brandeis, J., dissenting). Here, according to Southland, judicial process is preserved for important federal rights but not for important rights under state law. Such differential treatment is of questionable constitutionality. One of the decisive factors in *Marathon* was that Congress had vested the "adjunct" bankruptcy judges with powers over state-created rights far exceeding the powers it had vested in administrative agencies that adjudicate only rights of Congress' own creation. *Id.* at ....., 102 S.Ct. at 2878.

Congress' power under the Commerce Clause is, if anything, more circumscribed in controlling state court procedures than federal procedures. The control over state court dockets, including the right to a civil jury trial in the state courts, is not governed by the federal Constitution, but is a matter solely of state law and state concern. *Melancon v. McKeithen*, 345 F.Supp. 1025, 1036-1045 (E.D. La. 1972), *aff'd. mem.*, 409 U.S. 943 (1972), 409 U.S. 1098 (1973); *see U-Haul Co. v. Alabama State*, 294 Ala. 685, 316 So.2d 685 (1975) and *Butler v. Claxton*, 221 Ga. 620, 146 S.E.2d 763 (1966).

This analysis pinpoints the absurdity of Southland's contention. When Congress enacts protective legislation, it decides at that time whether the particular rights created require access to a judicial forum to assure their effectiveness. If so, predispute waiver of the right to a judicial forum is void. Only in the context of particular legislation can this determination be made. Yet Southland contends that Congress has utterly barred the states from ever making a similar determination regarding the enforcement of their own protective legislation wherever it touches upon inter-

state commerce. Any such blanket denial of access to state courts for vindication of important state policies would be beyond the authority delegated to Congress by the Constitution.

III

THE CALIFORNIA COURT'S DECISION TO CONSIDER CLASSWIDE ARBITRATION OF THE COMMON LAW CLAIMS DOES NOT IMPAIR ANY FEDERAL RIGHT

As discussed above, Southland had been litigating similar statutory and common law claims for two years in the California courts when the Keatings filed their class action. Before plaintiffs could move for class certification, Southland sought to compel arbitration, arguing that class proceedings were unavailable in an arbitral forum for lack of state legislative authorization.[43] The statutory claims have now been declared nonarbitrable as a matter of law. Thus, a class proceeding is contemplated in court in any event. One of the options available to the trial court is to send the common law claims to arbitration.[44] In such event, the California Supreme Court has authorized consideration of classwide arbitration of the common law claims, allowing Southland the option to litigate the entire action in court. Southland now argues that the exercise of that court's equitable powers is unconstitutional under the Supremacy Clause. It plainly is not.

A. The California Courts May Void the Arbitration Clause Altogether as Unconscionable Under General Principles of California Contract Law

The FAA ensures the validity and enforceability of arbitration agreements except ". . . upon such grounds as exist at law or in equity for the revocation of any contract."

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[43] *See supra* at 12-13 n. 8.

[44] *See* cases cited *supra* at 15 n. 12. The trial judge also has equitable jurisdiction to order the entire action to be adjudicated in court to avoid duplicative and bifurcated proceedings. *See* cases cited *supra* at 15 n. 11.

9 U.S.C. § 2. The initial question of validity is determined according to the applicable state law.[45] The Supreme Court of California has decided that there may exist "... grounds at law or in equity for the revocation ..." of the arbitration clause in Southland's standardized contracts of adhesion.

> It is common knowledge that arbitration clauses frequently appear in standardized contracts of adhesion. A primary consideration which has led courts to uphold such clauses, despite the adhesive nature of the contract, is the belief that arbitration is not oppressive and does not defeat the reasonable expectations of the parties. . . . If, however, an arbitration clause may be used to insulate the drafter of an adhesive contract from any form of class proceeding, effectively foreclosing many individual claims, it may well be oppressive and may defeat the expectations of the nondrafting party.

J.S.App. 25a (citations omitted).

The California Supreme Court was concerned with the twin specter of classwide wrongs going unredressed and the possibility of duplicative, individual arbitrations. Southland suggests that these concerns are without merit, but its supporting reasons merely emphasize the reasons why class actions were developed in the first place.

Southland asserts that there would be "[s]ubstantial economies," Op. Br. 40, if individual arbitrations should occur, but there is no way that many individual arbitrations can be handled as effectively and economically as one which determines all common claims. Absent a class or consolidated proceeding, there is no guarantee of consistency. There is no requirement that arbitrators give precedential weight to prior cases; nor can it be assumed that Southland would politely concur in an early finding of its liability so as to eliminate later arbitrations. Control over

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[45] *See supra* at 31.

how many times an issue had to be decided against it before it would concede the issue would reside with Southland, not the individual franchisees. But Southland considers numerous arbitrations unlikely. "[T]he true alternative to a class action in the instant litigation . . . is arbitration with a few claimants, not hundreds." Op. Br. 40. Precisely. This is why California considers the class action such an important remedial device. It prevents wrongdoers from retaining the benefits of their misconduct. *Fletcher v. Security Pacific National Bank,* 23 Cal.3d 442, 452, 153 Cal.Rptr. 28, 33, 591 P.2d 51, 57 (1979). The class action is often employed where a widespread practice injures large numbers of people but the amount of individual recovery would be insufficient to justify bringing an individual action.[46] It has been found particularly suited to the special circumstances arising, as here, from a standardized adhesion contract where the same provisions and practices apply to each member of the class.[47] The class action allows numerous individual claimants with no clout to command attention and redress.

The parties here are not equals—Southland has vastly superior bargaining power over each of the individual operators of its corner grocery stores. J.S.App. 6a. In *Ware,* this Court was also faced with an effort to defeat a class action by imposition of an arbitration provision in a similarly imbalanced setting. The unequal bargaining power of the nonunionized employee signing a standard form agreement to arbitrate was recognized as a strong state reason for voiding arbitration altogether as unfair. 414 U.S. 117, 131, 139 (1973). The same is true here.

In attempting to reconcile Southland's choice of arbitration with plaintiffs' right to pursue class relief, the California Supreme Court, if anything, erred in giving too

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[46] *Vasquez v. Superior Court,* 4 Cal.3d 800, 808, 94 Cal.Rptr. 796, 800, 484 P.2d 964, 968 (1971).

[47] *LaSala v. American Sav. & Loan Assn.,* 5 Cal.3d 864, 877, 97 Cal.Rptr. 849, 857, 489 P.2d 1113, 1121 (1971).

much weight to Southland's unilateral choice of arbitration.[48]

Rather than declare the arbitration clause completely invalid—which it might have done without impairing any right protected by the FAA—the California court remanded the case to the trial court to determine whether the inherent inequality and potential unfairness of arbitration in the setting of an adhesion contract could be cured by allowing class arbitration. The trial court was instructed to consider all available alternatives, including consolidation of arbitration proceedings.

There is nothing in that decision which even remotely threatens the liberal federal policy favoring arbitration. The California court did not invoke any contrary state policy. Actually, it leaned over backward to uphold the arbitration agreement in question.

B. State Courts Are Entitled to Apply Their Own Procedures in Enforcing A Right to Arbitrate Under the Federal Arbitration Act

This Court has long recognized that it does not have supervisory authority over state courts. Indeed, it has encouraged states to engage in procedural experimentation to meet changing social, economic and technological problems where no fundamental guarantees are infringed.[49] That principle is illustrated here.

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[48]Indeed, at least one state has chosen to void all arbitration clauses contained in contracts of adhesion. Iowa Code Ann. § 679A.1(2)(a) (West Supp. 1982).

[49]*Chandler v. Florida*, 449 U.S. 560 (1981), permitting television coverage in the courtroom in the face of a constitutional challenge: "[S]tates must be free to experiment. We are not empowered by the Constitution to oversee or harness state procedural experimentation; only when the state action infringes fundamental guarantees are we authorized to intervene . . . . In this setting, because this Court has no supervisory authority over state courts, our review is confined to whether there is a constitutional violation." *Id.* at 582-583; *See Johnson v. Louisiana*, 406 U.S. 356, 376 (1972) (Powell, J., concurring); *McKeiver v. Pennsylvania*, 403 U.S. 528, 547 (1971).

The FAA was envisioned as a statute governing federal court procedure.[50] Only section 2, declaring the validity, irrevocability and enforceability of agreements to arbitrate, embodies any national substantive principle. The remaining sections of the Act are primarily procedural in nature, governing stays (§ 3); the procedures to compel arbitration (§ 4); appointment of arbitrators (§ 5); form of applications to the court (§ 6); witness fees and appearances (§ 7); confirmation (§ 9); vacation (§ 10); correction of awards (§ 11); and motions relating thereto (§§ 12, 13). Several of these provisions, such as section 4, expressly rely on the Federal Rules of Civil Procedure to direct the manner of implementation, *e.g.*, service of the petition, request for jury trial. In addition, Federal Rule of Civil Procedure 81(a)(3) expressly makes the federal rules applicable to arbitration proceedings "to the extent that matters of procedure are not provided for in those statutes."

California has its own arbitration act, Cal. Civ. Proc. Code §§ 1280 *et seq.*, with substantive provisions nearly identical to section 2 of the FAA and with numerous procedural provisions on service, witness fees, motions and other incidents of such proceedings. The California courts apply the substantive principles of the FAA in appropriate cases, such as this one, but implement it with their own procedure. Indeed, that is what Southland invited the state courts to do here. *See supra* at 11-13 & nn. 7-8.

There is no basis—either in the history of the FAA or its interpretation by *any* court—to conclude that application of the Act requires a state court to replace state arbitration procedures with federal ones. To the contrary, the courts have uniformly recognized that in implementing section 2 of the Act, state courts apply their own procedure. *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*,

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[50] *See* discussion *supra* at 22-23 & nn. 23-25.

..... U.S. ....., 103 S.Ct. 927, 942-43 & n.32 (1983);[51] *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959); *Main v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 67 Cal.App.3d 19, 136 Cal.Rptr. 378 (1977); *Vigo Steamship Corp. v. Marship Corp.*, 26 N.Y.2d 157, 309 N.Y.S.2d 165, 257 N.E.2d 624, *cert. denied*, 400 U.S. 819 (1970). In *Vigo*, the New York court applied state procedural law to order consolidation of multi-party arbitration proceedings. The court considered, but rejected, the argument that federal law controlled the issue of consolidation. There is no theoretical reason why a class motion could not be considered by a state court followed by a classwide arbitration where such procedure otherwise appears superior to consolidation.

C. The Judiciary Has Always Played A Major Role in Structuring and Implementing Arbitration Procedures Under State and Federal Law

As the arbitration statutes themselves reveal, arbitration is not divorced from the courts; nor can it be. Although arbitration is invoked in the first instance by a private agreement, it relies on the courts for its enforcement. "Arbitration is not a separate proceeding independent of the courts, as was sometimes thought. The courts are brigaded with the arbitral tribunal in proceedings to compel arbitration or stay judicial trials, proceedings to enforce or

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[51]Southland's reliance on language in *Moses H. Cone Memorial Hospital* declaring section 2 of the Act a liberal federal policy favoring arbitration agreements notwithstanding any "state substantive or procedural policies to the contrary," ..... U.S. ....., 103 S.Ct. 927, 941 (1983), is misplaced. That declaration did not envision the substitution of federal procedural provisions for state procedures. It dealt solely with section 2 of the Act. The district court had stayed a petition to compel arbitration, deferring to parallel litigation in a state court involving the same issue of arbitrability. One of the reasons this Court reversed that order was because it was not clear that the state court in applying section 2 would have had available to it any procedure for compelling arbitration, such as is found in section 4 of the FAA.

quash subpoenas issued by arbitrators, . . . and proceedings to enforce or set aside arbitral awards." *Bigge Crane and Rigging Co. v. Docutel Corporation*, 371 F.Supp. 240, 246 (E.D.N.Y. 1973) (citations omitted). The federal courts have thus applied the Federal Rules of Civil Procedure to such matters as the service of a petition to compel arbitration,[52] motions to dismiss or for summary judgment,[53] pre-arbitration discovery,[54] and consolidation of multiparty arbitrations.[55] Consolidation of arbitration proceedings in federal court is authorized by the interaction of Rules 81(a)(3) and 42(a) where a dispute concerns several parties, each of whom has an agreement to arbitrate the dispute with one or more, but not all, of the others.[56] As the court in *Matter of Czarnikow-Rionda Co., Inc.*, 512 F.Supp. 1308 (S.D.N.Y. 1981), stated,

> Enforcement of an arbitration clause in federal court is controlled by the Federal Arbitration Act ("Act"), 9 U.S.C. §§ 1-14. Although the Act does not specifically provide for consolidated arbitrations, courts have fre-

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[52]9 U.S.C. § 4 specifically provides that the Federal Rules of Civil Procedure govern service of the petition. *See Hidrocarburos y Derivados, C.A. v. Lemos*, 453 F.Supp. 160, 165 n. 7 (S.D.N.Y. 1978).

[53]*Milwaukee Typo. U. v. Newspapers, Inc.*, 639 F.2d 386, 390 (7th Cir.), *cert. denied*, 454 U.S. 838 (1981).

[54]*See, e.g., Bigge Crane and Rigging Co. v. Docutel Corp.*, 371 F.Supp. 240, 244-46 (E.D.N.Y. 1973); *Ferro Union Corp. v. SS Ionic Coast*, 43 F.R.D. 11, 13-14 (S.D.Tex. 1967); *International Ass'n of Heat and Frost Insulators and Asbestos Workers v. Leona Lee Corp.*, 434 F.2d 192, 193-94 (5th Cir. 1970).

[55]*See, e.g., Compania Espanola de Pet., S.A. v. Nereus Ship.*, 527 F.2d 966, 974-75 (2d Cir. 1975), *cert. denied*, 426 U.S. 936 (1976); *Marine Trading Ltd. v. Ore. Intern. Corp.*, 432 F.Supp. 683, 684-85 (S.D.N.Y. 1977); *Robinson v. Warner*, 370 F.Supp. 828, 830-31 (D.R.I. 1974).

[56]Many state courts also authorize consolidated proceedings, *see* J.S.App. 27a, as do the Arbitration Rules of the New York Stock Exchange, *see, e.g.*, Rule 612(c)(1).

> quently ordered consolidated arbitration proceedings when the "interests of justice" so require either because the issues in dispute are substantially the same and/or because a substantial right might be prejudiced if separate arbitration proceedings are conducted.

Id. at 1309 (citations omitted).

Consolidation may involve an unlimited number of parties, each with its own version of the facts, claims or counterclaims for damages, defenses, and attendant battery of attorneys and witnesses, both percipient and expert. Because consolidation can involve several different arbitration clauses, the courts may mold the method of selection and number of arbitrators and resolve other conflicts among the agreements. *Id.* at 1309-10. "Thus, a party may be forced into a coordinated arbitration proceeding in a dispute with a party with whom he has no agreement, before an arbitrator he had no voice in selecting and by a procedure he did not agree to." J.S.App. 28a.

If by the interaction of Rules 81(a)(3) and 42(a), the federal courts can order consolidation, then by analogous reasoning it would seem that Rule 23, the class action rule, could form the basis for ordering class arbitration in an appropriate case. J.S.App. 26a-27a. Such will be for the federal courts to decide in controlling their own dockets.

The California Supreme Court, under its general equitable powers, has authorized consideration of a class arbitration procedure in the context of a standardized adhesion contract. The California Supreme Court directed the trial court upon remand to take into account any practical problems of class arbitration. It is premature to speculate how the trial court will resolve them. It is certainly improper to ask this Court to assume that the trial court will ignore the directive of the state supreme court to weigh all relevant factors before reaching a decision as to the viability of class arbitration.

D. Class Arbitration Is an Appropriate Experiment in Preserving Both Parties' Rights In the Context of an Adhesion Contract

Southland's argument that California has impaired the FAA merely by considering class arbitration requires Southland to prove that class arbitration is inconceivable under any circumstances under the FAA. It asks this Court to make such an absolute ruling despite the fact that there is no provision in the Act itself which bars such procedure and that the federal rules appear to permit it in an appropriate case.

There is simply no basis for this Court to declare that the class action and arbitration are inherently irreconcilable in their goals or implementation. Class actions are considered important by both the federal and state courts.[57] The class action promotes economical and efficient litigation by combining in one action common issues of fact and law, thereby preventing a multiplicity of actions. "Class actions serve an important function in our system of civil justice" by allowing vindication of small claims which might otherwise go unprosecuted because the result would be consumed by the cost. *Gulf Oil Co. v. Bernard*, 452 U.S. 89, 99 (1981). These small claims are of special concern to state courts since only those individual claims exceeding $10,000 are within federal diversity jurisdiction. *See Zahn v. International Paper Co.*, 414 U.S. 291 (1973).

Indeed, if upon remand Southland proves correct that there is a fundamental incompatibility between the procedures of arbitration and class actions,[58] Southland's arbi-

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[57] *General Telephone v. Falcon*, 457 U.S. 147 (1982); *American Pipe & Construction Co. v. Utah*, 414 U.S. 538, 551 (1974); J.S. App. 24a, *citing Richmond v. Dart Industries, Inc.*, 29 Cal.3d 462, 469, 174 Cal.Rptr. 515, 519, 629 P.2d 23, 27 (1981).

[58] Two state supreme courts have expressly approved a class arbitration, finding no incompatibility between arbitration and class action in an appropriate case. The Supreme Court of Georgia has approved combining a class action and arbitration in an adminis-

tration clause may well be declared invalid. But such a result seems unlikely. The supposed difficulties listed in Southland's "parade of horribles" are manageable without sacrificing any of the parties' essential rights.

i. The class certification motion with discovery, briefing and court hearing. These prearbitration proceedings need not consume lengthy amounts of time. The court has full power to control the timing and extent of discovery and is charged with proceeding to hear the class motion as soon as practicable after the filing of the action.[59] Discovery is not foreign to arbitration under the FAA; the federal courts order prearbitration discovery in appropriate circumstances.[60] These matters will not involve the court in all stages of the arbitration proceedings.

ii. Notice to the class. This presents no undue problems where the franchisees' addresses are in Southland's records. The form of notice and opt-outs are routine matters occurring only after the court determines that common issues exist and that they are suitable to resolution in one

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trative setting. In *Boynton v. Carswell*, 238 Ga. 417, 233 S.E.2d 185 (1977), *rev'd. on other grounds, Callaway v. Carswell*, 240 Ga. 579, 242 S.E.2d 103 (1978), taxpayers filed a class action in court protesting the reassessment of their properties. The court stated: "There is no legal or practical reason why this class controversy could not be settled in a class arbitration. The issue between each member of the class in these cases and the Joint Board of Assessors is identical . . . ." *Id.* at 582, 233 S.E.2d at 187. In *Stevenson v. Com. of Pennsylvania, Dept. of Revenue*, 489 Pa. 1, 413 A.2d 667 (1980), the court held that a class action was incorporated into the rules governing the arbitration proceedings before the administrative Board of Arbitration and Claims and that, accordingly, class actions were properly maintainable in the arbitrations. *Contra, Harris v. Shearson Hayden Stone, Inc.*, 82 A.D.2d 87, 441 N.Y.S.2d 70 (1981), *aff'd. mem.*, 56 N.Y.2d 627, 435 N.E.2d 1097, 450 N.Y.S. 2d 482 (1982). Southland itself recognizes that class actions and arbitration are not intrinsically incompatible. *See supra* at 12-13 n. 8.

[59]*City of San Jose v. Superior Court*, 12 Cal.3d 447, 453, 115 Cal. Rptr. 797, 801, 525 P.2d 701, 705 (1974).

[60]*See* cases cited *supra* at 44 n. 54.

arbitration. Notice in no way intrudes upon the arbitral process.

iii. Adequacy of class representative. Within the context of class actions, adequacy of representation primarily means that counsel for the class must be competent.[61] As to the individual class representative, there must be an initial determination at the time of certification that there is no conflict between the representative and the class.[62] Southland is not correct in suggesting that "adequacy" has to do with the day-to-day skill or diligence of the class representative or counsel, and that the court continually monitors these qualities in a class action trial, much like a foreman supervising his crew. That is not what "adequacy" means.

iv. The conditional nature of certification. Southland contends that because a class is only conditionally certified at the outset and may be decertified during the litigation, the court must exercise ongoing supervision, including review of the evidence at the arbitration. Under California law, however, decertification should occur only where changed circumstances exist; thus, the initial determination should rarely be upset.[63]

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[61] *Richmond v. Dart Industries, Inc.*, 29 Cal.3d 462, 478-79, 174 Cal.Rptr. 515, 525, 629 P.2d 23, 33 (1981); *Jordan v. County of Los Angeles*, 669 F.2d 1311, 1323 (9th Cir. 1982); *Lewis v. Curtis*, 671 F.2d 779, 788 (3d Cir. 1982); *Greenfield v. Villager Industries, Inc.*, 483 F.2d 824, 832 n. 9 (3d Cir. 1973).

[62] *McGhee v. Bank of America*, 60 Cal.App.3d 442, 450-51, 131 Cal.Rptr. 482, 488 (1976); *see Lewis v. Curtis*, 671 F.2d 779, 788 (3d Cir. 1982); *Senter v. General Motors Corp.*, 532 F.2d 511, 524-25 (6th Cir. 1976).

[63] *Green v. Obledo*, 29 Cal.3d 126, 172 Cal.Rptr. 206, 624 P.2d 256 (1981). By the use of a transcript, which is expressly provided for by the American Arbitration Association Rules of Commercial Arbitration, Rule 23, the court could review the proceedings, limited to the class certification issue, after the arbitrator completes the factfinding process. There would be no intrusion on the arbitration itself.

v. Other hypothetical objections by Southland to a class arbitration—supervision of any settlement, post-arbitration contests by intervening class members—likewise do not intrude upon the arbitration itself. Settlement discussions occur independently of—and often concurrently with—any arbitration proceeding. Post-arbitration attacks on an arbitration award are common and are always a matter for the courts. *See* 9 U.S.C. §§ 9, 10, 11; Cal. Civ. Proc. Code §§ 1285 *et seq.*

A class arbitration offers a speedier and more efficient resolution of claims than seriatim, duplicative arbitrations. Once liability on common claims is established, a procedure can be devised for determining the damages of each class member. Often hearings are not necessary. In this case, proof of damages will come largely from Southland's own accounting system. As to nondamage claims, the action seeks rescission, a remedy commonly held "manageable" in class actions.[44]

The class arbitration, being an untried procedure, will, of course, require ingenuity on the part of the courts. But Southland has not demonstrated that it is so inherently unworkable that it must be nipped in its first budding. As the California Supreme Court noted, the consolidated proceedings sanctioned by the federal courts and by California statute may much more greatly intrude upon the contractual aspects of the parties' agreement than would a class arbitration. J.S.App. 27a-28a. The class arbitration is really a two-party situation between the franchisor and representative franchisee. One determination of classwide disputes makes eminent sense especially where, as Southland states, the alternative to a class arbitration is a few scattered, individual arbitrations by which it would face only partial responsibility for any wrongdoing.

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[44]*See, e.g., Vasquez v. Superior Court*, 4 Cal.3d 800, 815, 94 Cal. Rptr. 796, 805, 484 P.2d 964, 973 (1971).

By concentrating solely on the asserted peril to arbitration posed by class proceedings, Southland hopes to divert this Court's attention from what really is at stake here. It is not arbitration which would be endangered by consideration of a class proceeding in an appropriate case, but class actions which would be virtually extinguished if arbitration could not accommodate them.

This Court is being asked to interpret the FAA as eliminating the class action device as a procedure for all claims encompassed by standardized contracts in interstate commerce. A corporation could insulate itself forever from liability for classwide wrongs merely by having the foresight to insert an arbitration clause in all of its forms.

The FAA was never intended to be used by parties of superior bargaining power to achieve such an unjust result. There is nothing in the nature or purpose of the Act which prevents a state in the exercise of its equitable powers over its own docket and procedures from neutralizing such an unfair tactic without disturbing the choice of forum.

CONCLUSION

For the reasons stated herein and in Appellees' Motion to Dismiss, this Court should dismiss this appeal for lack of jurisdiction or, in the alternative, affirm the decision of the California Supreme Court.

Respectfully submitted,

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